PIERCING THE FIDUCIARY VEIL

by
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Limited partnerships (LPs) and limited liability companies (LLCs) permit formation with a unique management structure in that these entities may be managed by another limited liability entity, such as a corporation. Thus, the true managers are those individuals who manage the manager. It is well settled that the managing entity, such as a corporate general partner, owes default fiduciary duties, but what of these second-tier managers? Technically, it is the managing entity that owes the duties, not the managing entity's owners, officers, and directors, yet courts have struggled with strict adherence to this separation when it would seem inequitable to do so. Unfortunately, courts and commentators have failed, thus far, to articulate a clear rule as to when fiduciary duties should attach to second-tier managers that also makes allowances for countervailing concerns regarding the scope of such a duty. This article offers an approach aimed at resolving this problem by simply reexamining what it is that courts are doing when they attach liability. In the process of doing so, this Article makes three major contributions to the existing scholarship. First, it is the only article to describe the three main approaches courts have adopted to address the problem. Second, the article explains why alternate equitable theories, as currently applied, are inadequate to address this issue. Finally, this Article offers a unique solution as to when fiduciary duties should attach to second-tier managers. Specifically, this article posits that liability should attach under a form of piercing the corporate veil. Unlike traditional piercing, which focuses on the abuse of the corporate form, this limited form of piercing, which I dub "piercing the fiduciary veil," should focus on the abuse of the control exercised by second-tier managers.

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I. INTRODUCTION

Limited liability entities are often created as a means of shielding their members from unlimited personal liability. Corporations shield the shareholders, limited liability companies ("LLCs") shield the members, and limited partnerships ("LPs") shield the limited partners. Typically, these entities centralize management of the entities allowing the investors, members, and/or limited partners to become passive participants in the enterprise. To deter agency costs, the individuals who take on management roles in these entities also assume fiduciary duties that flow in favor of those to whom their service is to benefit. However, this structure becomes complicated when the management structure takes on a two-tier (or perhaps more) structure in which the manager is not an individual, but rather a limited liability entity itself. For instance, in a common scenario, a limited partnership may have a general partner that is itself a corporation. This corporation may have a single shareholder who is the sole director and president of the corporation, or it may have multiple shareholders, board members, and officers. In either instance, a question may arise as to whether the officers, directors, and controlling shareholders[1] of the corporate general partner, which as an entity owes fiduciary duties to the limited partners, should also owe fiduciary duties to the limited partners.

[1] For ease, throughout this article, such parties will be collectively referred to as second-tier managers.

In *In re USACafes*,[2] the Delaware Chancery Court answered this question in the affirmative. Since this decision, a number of cases have turned the ultimate question of whether a fiduciary duty is owed on whether the individual second-tier manager exercised control over the entity that was owed a fiduciary duty. Thus, in a number of cases, a fiduciary duty has been found. An examination of these cases, however, demonstrates that the conduct often involves self-dealing and circumstances in which equity highly favored the finding of individual liability.

But, what of cases in which there has been no individual self-dealing? Suppose a corporate manager of a limited partnership decides to sell off assets because it is in the best interests of the corporation's shareholders but to the detriment of the limited partners. Should the law require a corporate officer or director to serve two masters in such an instance? If the question is only one of control, then it would appear that corporate managers have been placed in an unenviable Catch-22 in which they will be violating either the fiduciary duties owed to the shareholders or to the limited partners. This problem is one courts are likely to encounter with increasing frequency as alternate unincorporated forms, especially LLCs, are on the rise.[3] LPs and LLCs are also popular as the entity of choice for private equity and hedge funds, as well as for venture capital firms.[4] This particular use of entities with a second-tier management structure is likely going to bring further litigation, especially when the manager is managing more than one fund.[5]

If control by the second-tier managers gives rise to fiduciary duties, then conflicting duties are sure to arise on occasion, if not frequently. One way to avoid such a result would be a standard that requires more than control, and indeed Delaware courts have indicated that control may only give rise to limited duties.[6] But a uniform approach to the problem has been elusive, resulting in a lack of predictability with regard to the liability second-tier managers may face. This article seeks to forge a

[2] *In re* USACafes, L.P. Litig., 600 A.2d 43 (Del. Ch. 1991).

[3] Rodney D. Chrisman, Essay, *LLCs Are the New King of the Hill: An Empirical Study of the Number of New LLCs, Corporations, and LPs Formed in the United States Between 2004–2007 and How LLCs Were Taxed for Tax Years 2002–2006*, 15 FORDHAM J. CORP. & FIN. L. 459, 473 (2009) (illustrating the increased growth of LLCs over corporations); Mohsen Manesh, *Delaware and the Market for LLC Law: A Theory of Contractability and Legal Indeterminacy*, 52 B.C. L. REV. 189, 191 & n.10 (2011); Winnifred A. Lewis, Note, *Waiving Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 82 FORDHAM L. REV. 1017, 1020 (2013) (noting increases in the number of LPs and LLCs in Delaware).

[4] *See* Paul M. Altman et al., *Eliminating Fiduciary Duty Uncertainty: The Benefits of Effectively Modifying Fiduciary Duties in Delaware LLC Agreements*, BUS. L. TODAY. Feb. 2013, at 1, 2; Larry E. Ribstein, *Partnership Governance of Large Firms*, 76 U. CHI. L. REV. 289, 298–300 (2009).

[5] *See* Altman et al., *supra* note 4, at 2 ("Since the manager or an affiliate is typically managing other similarly situated funds, this structure creates an inherent conflict of interest for such managers.").

[6] *See infra* Part III.A.

new rule consistent with the goals that various courts have sought to achieve in finding liability.

Rather than view the existing cases as ones imposing control-based fiduciary duties, these cases should be viewed as a species of piercing the corporate veil cases. The "veil" in these instances, however, is not one which prevents unlimited personal liability for the acts of the corporation, but the veil which prevents fiduciary duties from flowing to the members of the entity that was under the second-tier managers' control. Thus, what courts are really doing when they impose liability is piercing the fiduciary veil that normally insulates these second-tier managers. As with a normal piercing claim, this form has its roots in equity but focuses specifically on control and an abuse of that control. This article proposes recognizing this type of piercing as a solution to the vexing question of when and why fiduciary duties should attach to second-tier managers. But, as this form of piercing is concerned with the abuse of control, rather than the abuse of the corporate form itself, different considerations should be relevant to the decision to pierce, though some considerations may overlap. Specifically, courts should examine the control exerted, whether a fiduciary duty was even violated (which will often require examination of the partnership or operating agreement), and, most importantly, the motives of the second-tier managers. This last consideration should examine whether the second-tier managers' actions can be explained on the grounds that he or she was acting primarily in a good faith effort to fulfill his or her obligations to the corporate manager.

Part II of this article provides an overview of the two primary business forms that lead to the second-tier manager situation—limited partnerships and limited liability companies. Part III discusses the different approaches courts have taken to the second-tier manager situation, starting with *USACafes*. It proceeds to describe three major approaches to when fiduciary duties will attach to second-tier managers: the Delaware limited duty approach, the Texas control approach, and the strict traditional approach, adopted in Illinois. Following this discussion, Part IV explains why alternate equitable theories, such as aiding and abetting, traditional piercing the corporate veil, and common law fiduciary duties are insufficient to reach the types of inequitable conduct that courts will most wish to address in a second-tier managed entity. Part V describes how piercing the fiduciary veil is the best way to address the various concerns raised by courts that wish to attach fiduciary duties to second-tier managers. It concludes by describing under what circumstances piercing the fiduciary veil is appropriate.

II. OVERVIEW OF SECOND-TIER MANAGED ENTITIES

A. *Structure and Third-Party Liability in LPs and LLCs*

Under the Uniform Partnership Act ("UPA") and the Revised Uniform Partnership Act ("RUPA"), the default status of two or more individuals entering into a joint enterprise with the intention of making a profit is a general partnership.[7] Usually, no filing with the state is required to obtain general partnership status, but this entity form does have legal consequences. For instance, unless specified otherwise in the partnership agreement, the partners in a general partnership split profits equally, regardless of capital contributions.[8] General partners are also jointly and severally liable to third parties for partnership liabilities.[9]

To avoid this result, many individuals opt to form a limited partnership. Unlike a general partnership, an LP must be registered with the state. Also, an LP has a bifurcated partnership structure with a general partner and at least one limited partner. The general partner may be a natural person or persons, or may be an entity, such as another LP or a corporation, and under the Revised Uniform Limited Partnership Act ("RULPA") the limited partner is not liable for the obligations of the limited partnership.[10] The general partner, however, remains individually liable for the liabilities of the partnership just as it would in a general partnership.[11] The general partner is also charged with running the LP,[12] though RULPA does not explicitly prohibit limited partners from taking part in and running the LP. However, RULPA does provide that limited partners can lose their insulation from liability in some circumstances if they are in fact controlling the LP.[13] RULPA provides:

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[7] Uniform Partnership Act (UPA) § 6 (1914). Section 101(6) of the Revised Uniform Partnership Act (RUPA) defines a partnership as "an association of two or more persons to carry on as co-owners a business for profit formed under Section 202, predecessor law, or comparable law of another jurisdiction." Uniform Partnership Act (RUPA) § 101(6) (1997). Section 202 of RUPA also provides that "(a) [e]xcept as otherwise provided in subsection (b), the association of two or more persons to carry on as co-owners a business for profit forms a partnership, whether or not the persons intend to form a partnership." RUPA § 202; *see* Sacramento E.D.M., Inc. v. Hynes Aviation Indus., 965 F. Supp. 2d 1141, 1150 (E.D. Cal. 2013) ("Whether or not the parties have entered into a partnership relationship generally depends on whether they intended to share in the profits, losses and the management and control of the enterprise."); Howard Gault & Son, Inc. v. First Nat'l Bank of Hereford, 541 S.W.2d 235, 237 (Tex. Civ. App.—Amarillo 1976, no writ) ("The statement in one of the agreements that the farming operation was not a partnership is not conclusive on the question of partnership. It is the intent to do the things that constitute a partnership that determines that the relationship exists between the parties, and if they intend to do a thing which in law constitutes a partnership, they are partners whether their expressed purpose was to create or avoid the relationship.").

[8] UPA § 18(a); RUPA § 401(b).

[9] UPA § 15 (assigning joint and several liability for tort liabilities but only several liability for contract liabilities); RUPA § 306(a).

[10] Revised Uniform Limited Partnership Act (RULPA) § 101 (1976) (amended 1985).

[11] *Id.* § 403(b).

[12] *Id.* § 403(a).

[13] *Id.* § 303(a).

> (a) Except as provided in subsection (d), a limited partner is not liable for the obligations of a limited partnership unless he [or she] is also a general partner or, in addition to the exercise of his [or her] rights and powers as limited partner, he [or she] participates in the control of the business. However, if the limited partner participates in the control of the business, he [or she] is liable only to persons who transact business with the limited partnership reasonably believing, based upon the limited partner's conduct, that the limited partner is a general partner.[14]

Thus, under RULPA, a limited partner who takes too active of a role in the management of the LP could risk personal liability, but this liability is limited to those individuals who reasonably believe the limited partner is a general partner.[15] RULPA also contains a laundry list of activities that, in and of themselves, do not mean the limited partner is in "control" of the LP, such as by "(1) being a contractor for or an agent or employee of the limited partnership or of a general partner or being an officer, director, or shareholder of a general partner that is a corporation";[16] "(2) consulting with and advising a general partner with respect to the business of the limited partnership";[17] or "(5) requesting, attending, or participating in a meeting of the partners or the limited partners."[18] The end result of these provisions is that a limited partner who is a passive investor will be able to reap the benefits of a profitable LP without worrying about personal liability, but even a limited partner who takes a larger role in the LP can remain insulated from liability.

A new Uniform Limited Partnership Act was promulgated in 2001 ("ULPA (2001)"), and a number of jurisdictions have adopted it.[19] ULPA (2001) does little to affect the formation process above as it still contains the standard structure of a general partner and one or more limited partners.[20] Unlike RULPA (and the original ULPA), which is linked to the general partnership statutes, ULPA (2001) delinks itself from the partnership acts and is meant to stand alone. Consistent with this theme, ULPA (2001) specifically addresses the powers and authority of the gen-

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[14] *Id.* (alterations in original). *See also* Delaware Revised Uniform Limited Partnership Act (DRULPA), DEL CODE ANN. tit. 6, § 17-303(a) (2013) (originally revised 1974); TEX. BUS. ORGS. CODE ANN. § 153.102(a) (West 2012).

[15] RULPA § 303(a).

[16] *Id.* § 303(b)(1); *see also* DRULPA § 17-303(b)(1); TEX. BUS. ORGS. CODE ANN. §§ 153.103(1)(A)–(C).

[17] RULPA § 303(b)(2); *see also* DRULPA § 17-303(b)(2); TEX. BUS. ORGS. CODE ANN. § 153.103(3).

[18] RULPA § 303(b)(5) & (6); *see also* DRULPA § 17-303(b)(4); TEX. BUS. ORGS. CODE ANN. § 153.103(5).

[19] According to the Uniform Law Commission's website, 18 states and the District of Columbia have all adopted ULPA (2001). *See Limited Partnership Act: Enactment Status Map*, UNIFORM L. COMMISSION (2014), http://www.uniformlaws.org/Act.aspx?title=Limited%20Partnership%20Act. Of note, Delaware and Texas are not among the states adopting ULPA (2001). *See id.*

[20] UNIFORM LIMITED PARTNERSHIP ACT (ULPA (2001)) § 102(11).

eral partner[21] and indicates that a limited partner lacks management rights and agency authority.[22] General partners remain liable to third-parties for the contract and tort obligations of the LP.[23] However, with regards to liability to third-parties, ULPA (2001) eliminates the "control rule" of RULPA, stating that "[a] limited partner is not personally liable, directly or indirectly, by way of contribution or otherwise, for an obligation of the limited partnership solely by reason of being a limited partner, even if the limited partner participates in the management and control of the limited partnership."[24]

LLCs are a hybrid, in many ways, of both partnerships and corporations. Like corporations, its owners, referred to as members, enjoy limited liability.[25] However, LLC members can choose the sort of management structure they want and either opt to be member-managed, which in small LLCs can mirror a partnership type of management structure, or be manager-managed.[26] Manager-managed LLCs mirror the LP structure in that there is a person(s) or entity that manages the LLC for the members.[27] Like LPs, the manager can be a natural person or an entity, including another LLC or a corporation. Unlike LPs, however, this manager is not normally individually liable for the obligations of the LLC. As the manager is not liable, members have no fear of liability regardless of whether they control the LLC.

B. *Fiduciary Duties in LPs and LLCs*

Due to RULPA's linkage to general partnership law, the general partner in a limited partnership owes fiduciary duties to the limited partnership and the limited partners. ULPA (2001) similarly provides that general partners owe such duties to the LP and limited partners.[28] Both

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[21] *See, e.g.*, *id.* §§ 402, 406.

[22] *Id.* § 302.

[23] *Id.* § 404(a).

[24] *Id.* § 303.

[25] UNIFORM LIMITED LIABILITY COMPANIES ACT (ULLCA) § 303(a) (1996) ("Except as otherwise provided in subsection (c), the debts, obligations, and liabilities of a limited liability company, whether arising in contract, tort, or otherwise, are solely the debts, obligations, and liabilities of the company. A member or manager is not personally liable for a debt, obligation, or liability of the company solely by reason of being or acting as a member or manager."); REVISED UNIFORM LIMITED LIABILITY COMPANY ACT (RULLCA) § 304(a) (2006).

[26] ULLCA § 404. Under the Revised Uniform Limited Liability Company Act, a LLC is automatically member-managed unless the operating agreement states expressly that it will be manager-managed. RULLCA § 407(a).

[27] *See* ULLCA § 404(b)(2) ("[A]ny matter relating to the business of the company may be exclusively decided by the manager or, if there is more than one manager, by a majority of the managers . . . ."). This article will focus on manager-managed LLCs as that is the context in which the second-tier management problem most frequently arises, such as when a limited liability entity acts as a manager.

[28] ULPA (2001) § 408(a).

RULPA (through its linkage to RUPA) and ULPA (2001) forbid elimination of the duty of loyalty, good faith and fair dealing, or unreasonably reducing the duty of care in the partnership agreement.[29] Both do allow, however, for identifying categories of activities that do not violate the duty of loyalty, for ratifying standards for authorizing specific self-dealing transactions, and for establishing standards for good faith and fair dealing (so long as those are not manifestly unreasonable).[30] Of particular note on the ability to modify fiduciary duties via agreement is the Delaware approach, which permits the wholesale elimination of fiduciary duties, "provided that the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing."[31]

The question of whether fiduciary duties are owed by limited partners to the LP has been much less straight-forward under RULPA due to its failure to address the matter. However, mere status as a limited partner should not create a fiduciary duty running from the limited partner to the LP or other partners. Nonetheless, some courts have confused the issue, but many of the cases that have found a fiduciary duty have relied upon factors beyond mere limited partnership status, such as the limited partner's actual control over the LP.[32] ULPA (2001) is much clearer, providing that a limited partner does not owe fiduciary duties by sole reason of being a limited partner; though the comments make clear that such duties may arise for other reasons, such as due to agency law.[33] Thus, a limited partner who also acts as the general partner owes fiduciary duties due to his or her status as the general partner and not due to limited partner status.

Due to the choice of management options, i.e. member-managed or manager-managed, whether fiduciary duties are owed in the LLC context depends upon which option is chosen. In member-managed LLCs, each member owes fiduciary duties of loyalty and care to the other members and the LLC.[34] Manager-managed LLCs, similar to LPs, impose fiduciary duties upon managers that flow to the LLC and its members.[35] Members

[29] *See* RULPA § 1105 (1976) (amended 1985); RUPA § 103(b) (1997); ULPA (2001) § 110.

[30] *See* RULPA § 1105; RUPA § 103(b); ULPA (2001) § 110.

[31] DRULPA, DEL. CODE ANN. tit. 6, § 17-1101(d) (2013) (originally revised 1974).

[32] *See, e.g.*, McBeth v. Carpenter, 565 F.3d 171, 177–78 (5th Cir. 2009) (stating that limited partners owe fiduciary duties in control settings); Int'l Equity Invs., Inc. v. Opportunity Equity Partners, Ltd., 472 F. Supp. 2d 544, 550–51 (S.D.N.Y. 2007) (explaining that limited partners who assume managerial control over a limited partnership will have fiduciary obligations); Red River Wings, Inc. v. Hoot, Inc., 751 N.W.2d 206, 218–19 (N.D. 2008) (noting that limited partners owe fiduciary duties of loyalty and care and good faith and fair dealing if they take part in the business of the partnership).

[33] ULPA (2001) § 305(a) & cmt. to subsec. (a).

[34] ULLCA § 409(a) (1996).

[35] *Id.* § 409(h). The Delaware LLC Act was amended effective August 1, 2013 to provide: "In any case not provided for in this chapter, the rules of law and equity, including *the rules of law and equity relating to fiduciary duties* and the law merchant,

who are not managers, however, owe no duties simply by virtue of their status as members.[36] The Uniform Limited Liability Company Act (ULLCA) of 1996 also made provision, however, for a member who exercised management rights to owe the same fiduciary duties as a manager.[37] The Revised Uniform Limited Liability Company Act (RULLCA) of 2006 modified this by simply stating that no duty was owed in a manager-managed LLC "solely by reason of being a member," but the comments clarify that this does not preclude duties that may arise for other reasons.[38] As with RULPA and ULPA (2001), ULLCA and RULLCA forbid the wholesale elimination of fiduciary duties, but do permit modification and a delineating of standards under which such duties are to be judged.[39] Also, as with its limited partnership act, Delaware is notable in that it permits the elimination of fiduciary duties (but not the duty of good faith and fair dealing) under its limited liability company act.[40]

With this framework for LPs and LLCs in mind, we see that these two business forms permit a system whereby the entity may be run by a general partner or manager that is not a majority or even a significant owner of the entity. As with shareholders in a corporation, these non-managing owners are shielded from liability. The general partner in an LP is not shielded from personal liability, but as the general partner can be a limited liability entity itself, personal liability of the ultimate owners can still

shall govern." DEL. CODE ANN. tit. 6, § 18-1104 (emphasis added). Prior to this amendment, Delaware's LLC act was silent on the matter of fiduciary duties, but courts had indicated that such duties existed. *See* Auriga Capital Corp. v. Gatz Props., 40 A.3d 839, 849–51 (Del. Ch.), *aff'd*, 59 A.3d 1206 (Del. 2012) (noting, however, that the Chancery Court should not have issued a pronouncement that the LLC Act imposes such default duties); Feeley v. NHAOCG, LLC, 62 A.3d 649, 660–61 (Del. Ch. 2012).

[36] ULLCA § 409(h). All members, whether in a member-managed or manager-managed LLC, owe the duty of good faith and fair dealing under the operating agreement. This was less clear under ULLCA, but is made explicit under RULLCA. *Compare* ULLCA § 409(d), (h), *with* RULLCA § 409(d), (g) (2006).

[37] ULLCA § 409(h)(3).

[38] RULLCA § 409(g)(5) & cmt. to subsec. (g)(5).

[39] ULLCA § 103(b); RULLCA § 110(d). The language of RULLCA section 110(d) permits the elimination of all of the duties specifically listed under the duty of loyalty under section 409(b), but this must be read in the context of the uncabining of the duty of loyalty under RULLCA. *See* RULLCA § 110 & cmt. to subsec. (d)(1). ULLCA limited the duty of loyalty to specific enumerated acts, while RULLCA does not; therefore, though the listed acts may be eliminated under RULLCA, other not enumerated loyalty duties remain and cannot be eliminated. *See id.* § 110 & cmt. to subsec. (d)(1).

[40] DEL. CODE ANN. tit. 6, § 18-1101(c) ("To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement, the member's or manager's or other person's duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement; provided, that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing.").

be avoided. In an LLC, there is less need to create a limited liability entity as the manager as individual liability does not attach, but nonetheless, many LLCs do have limited liability entities as managers. Though individual general partner or manager liability to third parties can be avoided through proper formation of these entities, in most jurisdictions the general partner or manager cannot avoid owing fiduciary duties to the limited partners or members. But, as the general partner or manager can be an entity, rather than a person, what does the fiduciary obligation mean to those in control of the general partner or manager? The next section discusses the problems that arise in such second-tier managed entities.

III. SECOND-TIER FIDUCIARY DUTIES IN LPS AND LLCS

A corporate general partner in an LP or corporate manager in an LLC, owes fiduciary duties, but as the corporation is a separate entity from those that run it, should this obligation necessarily flow to those who run the corporation? The Delaware case of *In re USACafes*[41] is one of the seminal cases addressing this problem. In that case, a corporation, USACafes, Inc., was reorganized into a LP with USACafes General Partner, Inc. acting as the general partner.[42] This corporate general partner was owned solely by Sam and Charles Wyly, who also sat on the board of directors.[43] The Wyly brothers were also limited partners in the limited partnership who owned 47% of the LP units.[44] The Wyly brothers and other directors of the corporate general partner approved a buy-out by Metsa Acquisition Corp. of substantially all of the assets of the limited partnership for $72.6 million (or $10.25 per unit).[45] As part of the buy-out, the directors (including the Wylys) received additional side payments of approximately $15–17 million.[46] The other limited partners sued the limited partnership as well as the corporate general partner and its directors individually for breach of fiduciary duty.[47] The plaintiff/limited partners claimed the defendants sold the limited partnership's assets at a bargain basement price due to the substantial side payments that were made to the Wylys and other directors.[48]

The directors moved to dismiss based on the rather straight-forward proposition that, although the general partner does owe fiduciary duties

[41] *In re* USACafes, L.P. Litig., 600 A.2d 43 (Del. Ch. 1991).

[42] *Id.* at 45.

[43] *Id.*

[44] *Id.* at 45–46.

[45] *Id.* at 45, 49–50.

[46] *Id.* at 46, 50.

[47] *Id.* at 45–46. The Wyly brothers were sued both in their roles as directors and also as the controlling shareholders of the corporate general partner. *Id.*

[48] *See id.* at 46 ("In essence, it claims that the sale of the [p]artnership's assets was at a low price, favorable to Metsa, because the directors of the [g]eneral [p]artner all received substantial side payments that induced them to authorize the sale of the [p]artnership assets for less than the price that a fair process would have yielded.").

to the limited partners, the members of the board of the corporate general partner only owed fiduciary duties to the stockholders of that corporation and not to the limited partners.[49] Chancellor Allen rejected this position under the circumstances. Though he could find no precedent dealing with the exact situation at issue, drawing from the law of trusts, he concluded that these second-tier managers owed a duty not to use the limited partnership's assets to serve the directors' own self-interests at the expense of the limited partnership.[50] Chancellor Allen's conclusion relied upon the traditional equitable concept that control of an asset imposes certain obligations, stating,

> I understand the principle of fiduciary duty, stated most generally, to be that one who controls property of another may not, without implied or express agreement, intentionally use that property in a way that benefits the holder of the control to the detriment of the property or its beneficial owner.[51]

Though Chancellor Allen found that a cause of action for breach of fiduciary duty did exist, he did not go so far as to impose the full spectrum of fiduciary duties, noting: "It is not necessary here to attempt to delineate the full scope of that duty. It may well not be so broad as the duty of the director of a corporate trustee."[52] Specifically, Chancellor Allen reserved judgment on other issues such as taking a corporate opportunity or waste, thus limiting his holding to the facts alleged.[53]

USACafes may have been one of the earliest cases to address the issue of when fiduciary duties are owed by second-tier managers, but it has certainly not been the last. Delaware courts have continued to explore the metes and bounds of the decision, and other jurisdictions have also had the opportunity to address the issue, though not always in line with Chancellor Allen's decision. Four approaches appear to have developed in response to the issue. Delaware has continued to address the issue on an ad hoc basis, upholding *USACafes*, but limiting its application. Other courts, in particular federal courts applying Texas law, appear to look at which party or parties are exercising control over the limited partner, but have failed to identify limiting principles. At least one commentator has advocated for full application of fiduciary duties flowing to the limited partnership from second-tier managers.[54] Finally, some commentators and at least one court take the position adopted by the defendants in *USACafes*—that there are no such duties owed by second-tier managers to the limited partnership.

[49] *Id.* at 47–48.
[50] *Id.* at 48.
[51] *Id.*
[52] *Id.* at 49.
[53] *Id.* at 49 n.3.
[54] *See infra*, notes 97–102, and accompanying text.

A. Delaware's Limited Duties Approach

Since the *USACafes* decision, Delaware courts have had multiple opportunities to reexamine the decision under various factual circumstances. Subsequent decisions have extended the reach of *USACafes*, as in who owes potential duties, but not the scope. For instance, in *Wallace ex rel. Cencom Cable Income Partners II, Inc., L.P. v. Wood*,[55] limited partners in Cencom Cable Income Partners II, Inc., L.P. sued not only the directors of the corporate general partner for breach of fiduciary duty, but also its officers, its parent corporation, and its affiliated entities.[56] The limited partners alleged that the defendants, through their control of the general partner, entered into transactions that highly leveraged the limited partnership for the purpose of generating management fees; they also alleged that the defendants usurped business opportunities available to the limited partnership.[57] Though the defendants attempted to distinguish *USACafes*, the court found it applicable, stating that addition of the parent and affiliated entities "may, arguably, be a minor distinction" and that the plaintiffs had pled sufficient control to bring such parties into the suit.[58] Thus, *USACafes*-type duties may be owed by parties beyond the corporate directors and can attach to other parties that exert control.[59] Other courts have further extended *USACafes* to apply in the corporate trust context,[60] and it has also been cited in cases involving LLC managers.[61]

[55] 752 A.2d 1175 (Del. Ch. 1999).

[56] *Id.* at 1178. The affiliated entities were entities created by the officers and directors with partnership funds. *Id.* at 1178–79.

[57] *Id.* at 1181.

[58] *Id.* at 1182 (citing, *inter alia*, James-River Pennington, Inc., v. CRSS Capital, Inc., Civ. A. No. 13870, 1995 WL 106554, at *11 (Del. Ch. 1995) (holding that a corporation owes the duty of loyalty to a partnership when the corporation controls the general partner) and *In re* Boston Celtics L.P. Shareholders Litig., No. C.A. 16511, 1999 WL 641902, at *4 (Del. Ch. Aug. 6, 1999) (stating "the general partner of a Delaware limited partnership and the directors of a corporate [g]eneral [p]artner who control the partnership, like directors of a Delaware corporation, have the fiduciary duty to manage the partnership in the partnership's interests and the interests of the limited partners" (footnotes omitted)).

[59] *See* Bigelow/Diversified Secondary P'ship Fund 1990 v. Damson/Birtcher Partners, No. Civ.A.16630-NC, 2001 WL 1641239, at *8 & n.42 (Del. Ch. Dec. 4, 2001) ("[T]hose affiliates of a general partner who exercise control over the partnership's property may find themselves owing fiduciary duties to both the partnership and its limited partners.").

[60] Cargill, Inc. v. JWH Special Circumstance LLC, 959 A.2d 1096, 1100, 1110–11 (Del. Ch. 2008).

[61] Bay Center Apartments Owner, LLC v. Emery Bay PKI, LLC, C.A. No. 3658-VCS, 2009 WL 1124451, at *9 n.43 (Del. Ch. Apr. 20, 2009) (addressing the applicability of *USACafes* by stating, "This court, to my knowledge, has not been presented with the question of whether the principles enunciated in *USACafes* and its progeny are applicable to the affiliates of an LLC's managing member. But, in the absence of developed LLC case law, this court has often decided LLC cases by looking to analogous provisions in limited partnership law.").

However, though the reach of the decision has been expanded, its scope has not. A number of opinions in Delaware have reiterated the holding from *USACafes* that the directors of the general partner have a "duty not to use control over the partnership's property to advantage the corporate director at the expense of the partnership."[62] But courts have been wary of expanding the duty any further, frequently noting Chancellor Allen's qualifier in *USACafes* that the full scope of the duty owed was not before him and that such duty "may well not be so broad as the duty of the director of a corporate trustee."[63] For instance, in *Feeley v. NHAOCG, LLC*,[64] the chancery court explicitly rejected that *USACafes* extended to duty of care claims.[65] Indeed, at least one court has indicated that the duty owed under *USACafes* is limited to "the duty not to use control over the partnership's property to advantage the corporate director at the expense of the partnership," as this places "a rational and disciplined way of protecting investors in alternative entities with managing members who are themselves entities, while not subjecting all the individuals who work for managing members to wide-ranging causes of action."[66]

Despite the reluctance of Delaware courts to expand the scope of the duty owed under *USACafes*, the decision itself has left open the possibility of further factual scenarios where a duty may lie. This gives rise to an awkward situation for directors of a corporate general partner who may be obligated to fulfill fiduciary duties owed to limited partners, even

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[62] *In re* USACafes, L.P. Litig., 600 A.2d 43, 49 (Del. Ch. 1991); *see also* Feeley v. NHAOCG, LLC, 62 A.3d 649, 670 (Del. Ch. 2012) (quoting *In re USACafes*, 600 A.2d at 49); *Bay Center Apartments Owner, LLC*, 2009 WL 1124451, at *10 (quoting *In re USACafes*, 600 A.2d at 49); *Cargill, Inc.*, 959 A.2d at 1121 (quoting *In re USACafes*, 600 A.2d at 49); *Wallace,* 752 A. 2d at 1180 quoting *In re USACafes*, 600 A.2d at 49). At least two other jurisdictions have found the *USACafes* approach persuasive. *See In re Appalachian Fuels*, 2014 WL 4230877, at *2 (Bkrtcy. E.D.Ky. 2014) (finding *USACafes* persuasive as to Kentucky law); *Vincent v. Beck,* 1995 WL 541470, at *2 (Minn. Ct. App. 1995) (citing *USACafes* and stating, "While we believe that the officers and directors of a corporate general partner can be held personally liable to the limited partners in the circumstances of a violation of fiduciary duty, this case does not present such a circumstance"). New York law, as applied by federal courts, appears to vacillate on whether *USACafes* applies. *Compare In re* Adelphia Communications Corp., 322 B.R. 509, 530, (Bkrtcy. S.D.N.Y. 2005) (citing to *Wallace* but applying N.Y. law, and stating that a duty may be owed by officer of corporate GP to limited partner) *with Anwar v. Fairfield Greenwich Ltd.*, 728 F. Supp.2d 372, 439–40 (S.D.N.Y. 2010) (applying N.Y. law and declining to adopt Delaware approach unless there was "an independent fiduciary relationship with the plaintiff").

[63] *In re USACafes*, 600 A.2d at 49; *see also Feeley*, 62 A.3d at 671 (quoting *In re USACafes*, 600 A.2d at 49); *Bay Center Apartments Owner, LLC*, 2009 WL 1124451, at *9–10 (quoting *In re USACafes*, 600 A.2d at 49); *Cargill, Inc.*, 959 A.2d at 1121 n.103.

[64] 62 A.3d 649 (Del. Ch. 2012).

[65] *Id.* at 671–72.

[66] *Bay Center Apartments Owner, LLC*, 2009 WL 1124451, at *10 (quoting *In re USACafes*, 600 A.2d at 49) (internal quotation marks omitted).

though the corporate general partner is the primary fiduciary.[67] Limiting the duty to simply forbid the type of self-dealing at issue in *USACafes* could provide some predictability for such directors, but at the cost of curtailing the ability to reach directors in other situations in which the interests of the primary corporate fiduciary are not impacted. For example, a failure to implement a monitoring system to catch officers of the limited partnership who may be embezzling funds would surely be a breach of the general partner's fiduciary duty and one for which it may be appropriate to go after the directors, though no self-dealing is involved.[68] Unfortunately, the *USACafes* decision does not provide a limiting principle to determine when the control, which gave rise to liability in that case, should not give rise to liability in other cases. Thus far, the only clear rule from Delaware jurisprudence is that such second-tier managers cannot self-deal at the expense of the controlled LP or LLC.

B. Texas and the Control Approach

Like the Delaware approach, some courts have looked to control to justify the imposition of fiduciary duties beyond simply the corporate general partner. Unlike Delaware, however, these courts have failed to articulate a limit to the extent of the duties or limit the situations under which a duty will extend beyond the corporate form. This "control approach" appears[69] to be the approach adopted in Texas, at least according to federal courts. In *McBeth v. Carpenter*,[70] StoneLake Ranch, LP was formed for the purpose of acquiring certain property in Travis County with StoneLake Management as the general partner.[71] James Carpenter was the president of the general partner as well as the general partner in two other limited partnerships, Texas Water Solutions ("TWS") and Texas Water Management ("TWM"), which were themselves limited partners

[67] *See* Gelfman v. Weeden Investors, L.P., 792 A.2d 977, 992 n.24 (Del. Ch. 2001) ("[The defendant's] argument in this regard raises yet again the awkward position occupied by directors of corporate General Partners . . . . Do they owe fiduciary duties to limited partners akin to those owed by corporate directors to stockholders, even though it is the corporate general partner which is the core fiduciary?") (internal citation omitted); MARTIN I. LUBAROFF & PAUL M. ALTMAN, LUBAROFF & ALTMAN ON DELAWARE LIMITED PARTNERSHIPS, § 11.2.11 (Supp. 2005).

[68] *See, e.g.*, *In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 970 (Del. Ch. 1996) ("[A] director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards.").

[69] "Appears" is used as Texas state courts have not explicitly adopted such an approach with regard to second-tier managed entities, but control has been cited as relevant to the inquiry as to whether limited partners should owe fiduciary duties. *See, e.g.*, Strebel v. Wimberly, 371 S.W.3d 267, 279 (Tex. App.—Houston [1st Dist.] 2012).

[70] 565 F.3d 171 (5th Cir. 2009).

[71] *Id.* at 175.

in StoneLake Ranch, LP.[72] Sandra McBeth and James Reynolds were two other limited partners in StoneLake Ranch, LP.[73] Ultimately, Carpenter purchased the same Travis County property with other investors, rather than through StoneLake Ranch, LP, and was able to resell the land at a profit.[74] McBeth and Reynolds sued Carpenter, TWS, and TWM for common law fraud and breach of fiduciary duty.[75] A jury found in favor of McBeth and Reynolds, and the defendants appealed.[76]

On appeal, Carpenter argued that he owed no fiduciary duties to the limited partners, and TWS and TWM argued that, as limited partners, they did not owe a fiduciary duty to the other limited partners in the limited partnership.[77] Relying on a Texas appellate case, *Crenshaw v. Swenson*,[78] and a previous Fifth Circuit opinion, *In re Bennett*,[79] both of which involved the second-tier management duties of partners in a general partner,[80] the court found that fiduciary duties extended to Carpenter due to his control over the limited partnership:

> A review of the record reveals that Carpenter was in a position of control in the StoneLake partnership and therefore owed Plaintiffs "the highest fiduciary duty recognized in the law." . . . Under Texas law, the usual general partner fiduciary duties apply in this two-tiered structure where Carpenter was acting as the general partner of a general partner.[81]

The Court also used control as a basis for finding that TWS and TWM owed duties, explaining:

> While [TWS] and [TWM] argue that there was no evidence at trial to show that a fiduciary relationship existed, the jury was entitled to find otherwise in light of evidence that Carpenter exerted control over StoneLake not just as general partner of StoneLake Management but also in his capacity as President of both [TWS] and [TWM]. Notably, Carpenter's trial testimony indicated that he was

[72] *Id.* All told, there were five limited partners—McBeth, Reynolds, Texas Water Solutions (of which Carpenter was the general partner), Texas Water Management (of which Carpenter was also the general partner), and two unnamed individuals. *Id.*

[73] *Id.*

[74] *Id.*

[75] *Id.*

[76] *Id.* at 175–76.

[77] *Id.* at 177.

[78] 611 S.W.2d 886 (Tex. Civ. App.—Austin 1980, writ ref'd n.r.e.).

[79] 989 F.2d 779 (5th Cir. 1993).

[80] *McBeth*, 565 F.3d at 177. The court cites *Crenshaw v. Swenson*, 611 S.W. 2d 886, 890 (Tex. Civ. App.—Austin 1980, writ ref'd n.r.e.) and *In re Bennett*, 989 F.2d at 789. *Crenshaw*, however, is a curious case as it involved a limited partnership that initially had a general partnership that acted as the general partner; at some point, the general partnership lost partners, resulting in only one individual as the general partner. 611 S.W.2d at 888. Nonetheless, the *Bennett* court found the general partnership must have existed prior to the complained of acts. *In re Bennett*, 989 F.2d at 789.

[81] *McBeth*, 565 F.3d at 178.

> often unable to identify "which hat" he was wearing when performing various acts related to StoneLake.[82]

Thus, the court found that, under Texas law, control over the limited partnership could justify imposition of fiduciary duties upon the second-tier manager as well as affiliated entities.[83]

Two years later, in *In re Harwood*, the Fifth Circuit again addressed the issue of fiduciary duties in a second-tier managed entity, this time in the context of a bankruptcy.[84] David S. Harwood was an officer and director of B & W Finance Co., which in turn served as the general partner of the limited partnership FNFS, Ltd.[85] Through his position at B&W, Harwood was able to obtain a number of loans from FNFS, secured by real property.[86] However, Harwood did not follow any formal procedures for obtaining the loans and failed to record the security interest in the county records.[87] B&W's board eventually conducted an audit, which discovered that the amount of the outstanding loans was quite large and that they were in fact unsecured and subordinate to other creditors.[88] Harwood was terminated, owing FNFS almost a million dollars in principal and interest.[89] Harwood subsequently filed Chapter 7 bankruptcy, seeking to discharge his indebtedness, and FNFS filed suit challenging his ability to do so under section 523(a)(4) of the Bankruptcy Code, which provides an "exception to discharge for debts arising from 'defalcation while acting in a fiduciary capacity . . . .'"[90]

As with other cases discussed above, Harwood claimed that he owed fiduciary duties to B&W, but not to FNFS.[91] Thus the Fifth Circuit was faced with whether Harwood, in his role as an officer and director of the general partner B&W, owed fiduciary duties to the limited partnership.[92] Relying upon *Crenshaw*, *Bennett*, and *McBeth*, the court focused on the degree of control exercised over the limited partnership by Harwood, stating:

> We conclude that an officer of a corporate general partner who is entrusted with the management of the limited partnership and who exercises control over the limited partnership in a fashion analogous to *Bennett* and *McBeth* owes a fiduciary duty to the partnership that satisfies Section 523(a)(4). We emphasize that it is not only the control that the officer actually exerts over the partnership, but also

[82] *Id.* at 178–79.
[83] *Id.* at 177–78.
[84] 637 F.3d 615, 617 (5th Cir. 2011).
[85] *Id.*
[86] *Id.*
[87] *Id.*
[88] *Id.* at 618.
[89] *Id.*
[90] *Id.* at 618–19 (quoting 11 U.S.C. § 523(a)(4) (2012)).
[91] *Id.* at 620.
[92] *Id.*

> the confidence and trust placed in the hands of the controlling officer, that leads us to find that a fiduciary relationship exists sufficient for the purposes of Section 523(a)(4).[93]

Thus, the court added an element of confidence and trust that must be placed in the officer. Turning to the facts of the case, the court agreed with the bankruptcy court that the entrustment in Harwood to manage FNFS's affairs by B&W's board, coupled with the complete control he exercised over the partnership's management, compelled a conclusion that he owed the duties of a fiduciary to the limited partners.[94]

Other courts have applied a "control" theory to assign liability,[95] sometimes citing to the Texas line of cases in support.[96] This line of cases is consistent with Professor Robert W. Hamilton's view that such liability should extend to all such controlling managers:

> Since the corporate general partner has complete control over the management of the limited partnership, and the managers of the corporation have complete power over the general partner, it seems plausible to impose the fiduciary duties owed by the general partner upon those managers. The justification for this conclusion is that the managers of the corporate general partner have complete control over the management of the limited partnership and therefore should have responsibility for abuse of that control to persons relying on them. Indeed, this is the classic situation in which courts imply the existence of fiduciary duty.[97]

The "control" approach is attractive as it responds to efforts to evade partnership duties and liability by simply creating a second-tier level of management.[98] However, the effect of such a rule is that corporate gen-

[93] *Id.* at 622.

[94] *Id.* at 624.

[95] *See, e.g.*, Andrews v. Wells (In re Wells), 368 B.R. 506, 512 (Bankr. M.D. La. 2006) (applying Louisiana law and citing approvingly to 5th Circuit precedent); *In re* Abrams, 229 B.R. 784, 791 (9th Cir. 1999); Lincoln Nat'l Life Ins. Co. v. Silver, 966 F. Supp. 587, 619–20 (N.D. Ill. 1995) (applying New Mexico law and finding a venture capitalist who controlled limited partnerships through his control of the general partner had breached fiduciary duties owed to the limited partnership and limited partners).

[96] *See In re Abrams*, 229 B.R. 784 at 790–92 ("However, we need not make a general holding based on formal partnership structures, for we find the reasoning in *Bennett* persuasive and applicable under California law. Here, Abrams exercised a level of control similar to those exerted by the second-tier partners in the *Bennett* and *Crenshaw* cases."); *see also In re Bennett*, 989 F.2d 789–90 (interpreting Texas partnership law to impose fiduciary duties based on the control that the second-tier general partner had on the enterprise); *Crenshaw v. Swenson*, 611 S.W.2d 886, 890 (Tex. Civ. App. 1980) ("In a limited partnership, the general partner acting in complete control stands in the same fiduciary capacity to the limited partners as a trustee stands to the beneficiaries of the trust.").

[97] Robert W. Hamilton, *Corporate General Partners of Limited Partnerships*, 1 J. SMALL & EMERGING BUS. L. 73, 87–88 (1997).

[98] *See In re Abrams*, 229 B.R. 784 at 792 ("A general partner-to-be could add a second partnership "layer" consisting of himself or herself and a phantom limited

eral partner managers will almost always be subject to such fiduciary duties due to the control they exert. "Control" offers little in the way of limitation and leads to potential conflicts of interest when a director of a corporate general partner owes divergent duties. Hamilton recognizes this possibility, but argues that in such situations, the duties owed to the limited partners enjoy a superior status.

> Directors of such a corporate general partner may face divided and inconsistent loyalties: to the shareholders and creditors of the corporate general partner, on the one hand, and to the limited partners of the limited partnership, on the other. If the conflict is direct and unavoidable, the directors may be able to avert the conflict by foregoing a transaction entirely. On the other hand, one may argue that foregoing a transaction is a violation of the fiduciary duty owed to both beneficiaries, to the corporate general partner, and to the limited partners. As suggested earlier, if the conflict is unavoidable, the duty to limited partners should trump the duty to shareholders and creditors of the corporate general partner. Any other rule leaves innocent parties without remedy, encourages directors to authorize breaches of fiduciary duty if they might profit personally from the breach, and almost certainly is inconsistent with the reasonable expectations of limited partners that invest capital in the venture.[99]

Hamilton's reasoning, however, assumes much and is not entirely accurate.

First, to say that any other rule leaves an innocent party without remedy ignores the possibility that a recovery may be obtained from the general partner itself. It may very well be that in some instances, the general partner has insufficient funds to pay all claims in full, but if this is due to undercapitalization or the movement of funds from the corporate general partner to the shareholders, then such factors may be better dealt with by a traditional piercing claim.[100] The claim that any other rule "encourages directors to authorize breaches of fiduciary duty if they might profit personally"[101] is also overly broad as it ignores the duties such managers do have to the corporate general partner. Such managers would not be able to engage in conduct, such as self-dealing, if it breached a fiduciary duty owed to the corporate general partner, assuming there are shareholders or other directors willing to bring suit. Indeed, in this vein

partner simply to insulate himself or herself from a potential nondischargeability determination while maintaining the same level of control.").

[99] Hamilton, *supra* note 97, at 96 (footnote omitted).

[100] *See* Laborers' Pension Fund v. Lay-Com, Inc., 580 F.3d 602, 610–12 (7th Cir. 2009) (recognizing a "laundry list" of piercing factors and listing undercapitalization as "the single most important factor in the veil-piercing analysis" aside from indicia of corporate form and common control); DeWitt Truck Brokers, Inc. v. W. Ray Flemming Fruit Co., 540 F.2d 681, 685–87 (4th Cir. 1976) (listing undercapitalization as a factor); *see also* Franklin A. Gevurtz, Corporation Law § 1.5.7 (2d ed. 2010) (discussing inadequate capitalization as a grounds for piercing).

[101] Hamilton, *supra* note 97, at 96.

it could be said that Hamilton's approach ignores the reasonable expectations of the owners of the manager entity. The shareholders of a corporation expect the board members to look out for the best interests of the corporation. Should a corporation later become a general partner of an LP, under Hamilton's theory, those expectations should be cast aside in favor of a now-superior set of obligations of the directors to look after the limited partnership.

Finally, while it may be true that the reasonable expectations of the limited partners includes an expectation of loyalty and care, if the limited partners know that there is a corporate general partner, it does not necessarily flow that such partners know who the directors are, or that they expect such directors to make decisions detrimental to the corporation for their sake. Overall, these "control" justifications seem to assume a situation in which a small number of limited partners invest in a venture where they know the person or persons running the general partner and the general partner is a small entity 100% owned by its directors or managers. While this certainly describes a number of situations, a rule based on such broad assumptions invites uncertainty when the facts do not fit. For instance, a corporate general partner, with many shareholders, could manage a limited partnership with different and numerous limited partners.

The lack of any limiting principle under a "control" approach is also troubling. If "control" is the only characteristic necessary for fiduciary duties to attach, then directors of corporate general partners will almost always owe de facto fiduciary duties (though some officers and passive shareholders may be able to use lack of control as a defense). This imposition presumably extends to the full panoply of duties and imposes such duties without regard to possible conflicts that could arise as between duties owed to the corporate general partner and duties owed to the limited partners.[102] The only limiting principle that might appear in the discussion of Texas law is the *Harwood* addition of an element of confidence and trust that must be placed in the controlling person, but it is unclear what this element adds. When would a controlling director not be in a position where confidence and trust was placed in his or her hands? And who must place the trust? In *Harwood*, it was the board of directors of the corporate general partner that placed trust in Harwood, not the limited partners.[103] Furthermore, was the added element only necessary due to Harwood's role as an officer? In sum, it seems doubtful that the confidence and trust elements add a meaningful limiting principle to the imposition of fiduciary duties, and the scope of such a requirement is unclear from the *Harwood* opinion.

[102] As noted above, Hamilton's solution is to simply have the latter duties trump. *See id.*

[103] In re Harwood, 637 F.3d 615, 623 (5th Cir. 2011).

C. *The Strict Traditional Approach*

The last approach to such second-tier duties takes a strict approach to the imposition of fiduciary duties based upon the structure of the entity. Such an approach was described by Chancellor Strine in *Gotham Partners, L.P. v. Halwood Realty Partners, L.P.*[104] as follows:

> When limited partners contract to join a limited partnership run by a corporate general partner, a rote traditional approach would impose fiduciary duties solely upon the corporate general partner as an entity. . . . Under this more strictly traditional approach, the limited partners would therefore be able to look to only the corporate general partner in the first instance to seek redress for any breach of duty. Only if there had been abuse of the corporate form by the owners of the corporate general partner that would justify veil piercing would the limited partners be able to look beyond the corporate partner to others for redress.[105]

Under such an approach, the question of whether a second-tier manager in a LP or LLC owes fiduciary duties relies solely on the availability of some other theory of ignoring the corporate form. Absent such a theory, no fiduciary duties attach.

Though Delaware and Texas reject such an approach, Illinois has adopted it. In *Franz v. Calaco Development Corp.*,[106] Franz, a limited partner in Calaco Limited Partnership, sued the general partner, Calaco Development, and its chief operating officer, Casalino (who had a 40%-ownership stake in Calaco Development).[107] It was alleged that, among other things, the defendants breached fiduciary duties owed to the limited partner by selling property owned by the limited partnership to the general partner at a discount.[108] The trial court declined to hold Casalino personally liable as a fiduciary.[109] On appeal, plaintiff argued that Casalino should be held liable due to his relationship to the limited partners, but the court refused to ignore the corporate form shielding Casalino, stating: "Because a director, officer, or shareholder may be held personally liable for corporate acts only where there is reason to set aside the corporate form plaintiff's argument fails."[110]

Though the issue of imposing fiduciary duties based upon control was not squarely before the court in *Franz*, five years later, in *1515 North Wells, L.P. v. 1512 North Wells, L.L.C.*, an Illinois appellate court addressed the issue directly.[111] There a limited partner, Bracken, sued the corporate general partner and its owners, Sutherland and Pearsall, for breach of fi-

[104] No. CIV.A.15754, 2000 WL 1476663 (Del. Ch. Sept. 27, 2000).
[105] *Id.* at *20.
[106] 818 N.E.2d 357 (Ill. App. 2004).
[107] *Id.* at 362–63.
[108] *Id.* at 364.
[109] *Id.* at 365–66.
[110] *Id.* at 365 (citations omitted).
[111] 913 N.E.2d 1 (Ill. App. 2009).

duciary duty based upon the general partner's selection of a Sutherland and Pearsall-owned general contractor to build a condominium.[112] Bracken argued that, under *USACafes*, it was not necessary to pierce the corporate veil to reach Sunderland and Pearsall.[113] The court soundly rejected this approach, stating: "Illinois has not adopted the view taken in *USACafes*. In Illinois, a corporation is 'an entity separate and distinct from its officers, shareholders, and directors, and those parties will not be held personally liable for the corporation's debts and obligations.'"[114]

The strict traditional approach is an alluring approach, not just because it is easy to apply, but also in that it arguably gives the most deference to freedom of contract. The limited partnership is an agreement which has the effect, via statute, of granting the limited partners limited liability, but which leaves the management to a general partner. It can be argued that, as part of this arrangement, the limited partners that enter into a limited partnership with a corporate general partner are aware that fiduciary duties will be owed not by the corporate managers, but by the corporation itself. Given that the duties themselves can be modified, or in Delaware completely eliminated,[115] it should come as no surprise that the duties, which arise via statute due to a contractual relationship, are limited to the contracting parties, absent an equitable claim such as piercing the corporate veil.

Such an approach, however, ignores the realities under which many LPs and LLCs are formed. Frequently, the corporate general partner or manager is owned by individuals who are themselves limited partners. The limited partners may all know and trust one another, at least at the beginning, and the issue of corporate separateness may have never crossed their minds in the context of fiduciary duties. But aside from these realities, such an approach further ignores the inequity of permitting corporate managers to use the corporation as a shield to breach of fiduciary duty claims. A basis for having fiduciary duties is to prevent the one in control of another's asset from abusing that control.[116] The corporation, which can only act through agents and directors, is a poor fiduci-

[112] *Id.* at 4.

[113] *Id.* at 10.

[114] *Id.* (quoting Tower Investors, LLC v. 111 East Chestnut Consultants, Inc., 864 N.E.2d 927, 941 (Ill. App. Ct. 2007)).

[115] *See* DEL. CODE ANN. tit. 6, § 18-1101(c).

[116] *See* Crenshaw v. Swenson, 611 S.W.2d 886, 890–91 (Tex. Civ. App.—Austin 1980, writ ref'd n.r.e.); LARRY E. RIBSTEIN & PETER V. LETSOU, BUSINESS ASSOCIATIONS § 9.01[B][1] (4th ed. 2003) (noting that fiduciary duties help ensure that corporate managers act in the best interest of the shareholders to reduce agency costs); Lubomir P. Litov et al., *Lawyers and Fools: Lawyer-Directors in Public Corporations*, 102 GEO. L.J. 413, 420 (2014) (discussing the separation of ownership and control and how fiduciary duties are meant to counteract agency costs); Spencer Weber Waller, *Corporate Governance and Competition Policy*, 18 GEO. MASON L. REV. 833, 836 (2011) (discussing the direct link between the separation of ownership and control described by the Berle-Means Thesis and fiduciary duties).

ary if its managers have little incentive to force the corporate manager to fulfill these duties.[117] While it is true that alternate theories, such as piercing the corporate veil, offer an avenue to relief, such theories are difficult to succeed under, as discussed *infra*.[118] Furthermore, the theory of piercing the corporate veil, which is well recognized, has its basis in equity. It makes little sense to ignore highly inequitable conduct on the part of corporate managers based upon corporate separateness, when an equitable theory such as piercing exists in recognition of the inequities that would result in some situations if the corporate form is not ignored. In other words, the strict traditional approach should yield when the equities justify ignoring the corporate form, just as they do in piercing cases.

IV. THE FAILURE OF ALTERNATE THEORIES TO EXPLAIN EXTENSION OF FIDUCIARY DUTIES TO THE SECOND-TIER MANAGERS

In light of the failure of courts to identify a single rule as explaining the attachment of fiduciary duties to second-tier managers, it is tempting to seek a unifying explanation under other theories of law. Three such theories are aiding and abetting breach of a fiduciary duty, piercing the corporate veil, and imposition of common law fiduciary duty.[119] A review of these theories, however, demonstrates that they are inadequate for either explaining the currently decided cases, or for reaching all of the types of conduct that would concern a court in equity.[120] But despite their shortcomings, a review is useful in delineating what characteristics a unifying theory should possess.

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[117] *See Crenshaw*, 611 S.W.2d at 888. This is not to say that other incentives, such as general reputation, do not exist, but the stick of enforcement is still lacking.

[118] *See infra* Part IV.

[119] *See* Hamilton, *supra* note 97, at 90 (listing aiding and abetting, piercing, fraudulent conveyance, and unjust enrichment as some of the alternative theories of recovery).

[120] *See* Christine Hurt et al., Bromberg and Ribstein on Partnership § 16.07(a)(8) (2014-2 Supp.); Hamilton, *supra* note 97, at 90. Hamilton explains the recurrence of such alternate theories in quite practical terms, stating: "An interesting question is why courts rely on these secondary theories rather than addressing directly the scope of the duties owed by the managers of corporate general partners. The most likely answer is that litigation is brought in order to obtain a recovery on *some* theory rather than to test the *best* theory. When limited partners bring suit for claims of injury caused by actions of the general partner, they normally sue the limited partnership, the corporate general partner, its directors, its officers, and its shareholders. If, in fact, a breach of fiduciary duty occurred—and particularly if the shareholders or managers of the corporate general partner have enriched themselves at the expense of the limited partnership—the plaintiffs and the court may prefer to rely on familiar principles such as piercing the corporate veil, aiding and abetting, or unjust enrichment rather than to test less well-charted waters. The theory may be narrower but the results are the same as the direct imposition of fiduciary duties on the directors or officers of the corporate general partner." *Id.* (footnote omitted).

A. Aiding and Abetting

Aiding and abetting the breach of a fiduciary duty is a recognized claim in a number of jurisdictions, including Delaware and Texas.[121] In *Mabrey v. Sandstream*, the Texas court of appeals articulated that the cause of action for a breach of fiduciary duty must, in equity, extend to aiders and abettors so that they will be "effectively denied the benefits and profits flowing from the wrongdoing."[122] The basic elements of such a claim are: "(1) the existence of a fiduciary relationship; (2) a breach of the fiduciary's duty; (3) knowing participation in that breach by the alleged aider and abettor; and (4) damages proximately caused by the breach."[123] These elements vary somewhat in jurisdictions that recognize the cause of action. For instance, Delaware requires that an aider and abettor be a non-fiduciary.[124] Texas requires that the aider and abettor participate "willfully and knowingly."[125] Other jurisdictions add that the aider and abettor's assistance be "substantial."[126] These differences do not affect the analysis, however, as the major shortcoming of this cause of action as a tool to address the conduct of second-tier managers derives from the breach of a fiduciary duty element, which is shared in all of the jurisdictions.[127]

[121] *See* Richard C. Mason, *Civil Liability for Aiding and Abetting*, 61 BUS. LAW. 1135, 1159 (2006) (noting that 18 states have recognized the cause of action); *see also* Cantor Fitzgerald, L.P. v. Cantor, No. C.A. 16297, 1998 WL 326686, at * 5 (Del. Ch. June 16, 1998); Mabrey v. Sandstream, Inc.,124 S.W.3d 302, 316 (Tex. App.—Fort Worth 2003, no pet.). Illinois does not recognize aiding and abetting, but does recognize the related tort of knowingly participating in or intentionally inducing a breach of fiduciary duty. *See In re* Chicago Trading Grp., Inc., No. 97 B 19843, 2001 WL 40071, at *5 (Bankr. N.D. Ill. Jan. 17, 2001). Under this theory, "a third party who knowingly participates in or induces a breach of duty by an agent is liable to the person to whom the duty is owed, provided that the third party obtained a benefit from the breach." *Id.*

[122] 124 S.W.3d at 316 (quoting Elcor Chem. Corp. v. Agri-Sul, Inc., 494 S.W.2d 204, 212 (Tex. Civ. App. 1973) (internal quotation marks omitted)).

[123] 3 WILLIAM MEADE FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF CORPORATIONS § 1001.50 (Rev. vol. 2010). *See also* RESTATEMENT (SECOND) OF TORTS § 874 (1979). ("A person who knowingly assists a fiduciary in committing a breach of trust is himself guilty of tortious conduct and is subject to liability for the harm thereby caused.").

[124] *Cantor Fitzgerald, L.P.*, 1998 WL 326686, at *5.

[125] *Mabrey*, 124 S.W. 3d at 316 (emphasis omitted) (quoting *Elcor Chem. Corp.*, 494 S.W.2d at 212).

[126] Mason, *supra* note 121, at 1159. *See also* Thornwood, Inc. v. Jenner & Block, 799 N.E.2d 756, 768–69 (Ill. App. Ct. 2003) (applying general law of aiding and abetting); Yuko Ito v. Suzuki, 57 A.D.3d 205, 208 (N.Y. App. Div. 2008).

[127] *See Cantor Fitzgerald, L.P.*, 1998 WL 326686, at *5 (citing CPM Indus. v. Fayda Chems. & Minerals, Inc., No. 15996, 1997 WL 770683, at *7 (Del. Ch. Nov. 26, 1997)); *Mabrey*, 124 S.W.3d at 316 (quoting *Elcor Chem. Corp.*, 494 S.W.2d at 212); Mason, *supra* note 121, at 1159. An additional element that could be problematic is the third that requires "knowing participation." Some courts have held that the knowing element can be met by constructive knowledge. *See* Chem-Age Indus., Inc. v. Glover, 652 N.W.2d 756, 775 (S.D. 2002); Katerina P. Lewinbuk, *Let's Sue All the*

Under this element, there must be a breach by the LP's general partner or LLC's manager before liability can attach to a second-tier manager. But it is easy to envision scenarios in which the second-tier manager engages in conduct that evades liability under this element simply by sidestepping the entity that owes the duty. For instance, assume that a limited partnership retains the duty of loyalty and designates under the partnership agreement that the corporate general partner cannot develop real estate in a geographical area. A director of the corporate general partner learns of an underpriced lot of real estate within the designated area and develops it himself. Because the corporate general partner has not breached a fiduciary duty, aiding and abetting will not help the limited partners should they wish to bring suit.[128] Chancellor Allen similarly recognized this shortcoming in the *USACafes* decision, noting that though aiding and abetting liability could reach some conduct, other self-dealing transactions might escape liability—"for example[,] the use by a director of confidential information concerning the partnership's business not yet known by the board of the general partner, [where] there may be no breach of loyalty or care by the general partner itself to abet."[129]

Though the conduct at issue in *USACafes* may have fallen within the aiding and abetting theory, other cases, such as *Harwood*, would present problems for such a theory. At issue in that case was Harwood's conduct, through various misrepresentations, to obtain large loans.[130] Though the general partner, through the board of directors, approved the loans, it

Lawyers: The Rise of Claims Against Lawyers for Aiding and Abetting a Client's Breach of Fiduciary Duty, 40 ARIZ. ST. L.J. 135, 151–53 (2008) (discussing a split in authority on the knowledge element with regard to attorney liability for aiding and abetting). Other courts have required actual knowledge of the breach. Miles Farm Supply, LLC v. Helena Chem. Co., 595 F.3d 663, 666 (6th Cir. 2010) (applying Kentucky law); Terrydale Liquidating Trust v. Barness, 611 F. Supp. 1006, 1015, 1027 (S.D.N.Y. 1984) (applying Missouri law); Cahaly v. Benistar Prop. Exch. Trust Co., 885 N.E.2d 800, 810 (Mass. 2008) (discussing New York law); Douglas R. Richmond, *Migratory Law Partners and the Glue of Unfinished Business*, 39 N. KY. L. REV. 359, 413 (2012) ("The core of an aiding and abetting claim is the defendant's knowing participation in the primary violator's alleged misconduct. The defendant's knowledge of the misconduct must be actual rather than constructive for liability to attach." (footnote omitted)). In such jurisdictions, a defense could be raised that the corporate managers did not have actual knowledge of a breach. This defense would likely fail when self-dealing is involved, but could be successful when the breach at issue involves waste or failure to monitor claims.

128 *See Cantor Fitzgerald, L.P.*, 1998 WL 326686, at *5; *Mabrey*, 124 S.W.3d at 316 (quoting *Elcor Chem. Corp.*, 494 S.W.2d at 212); Mason, *supra* note 121, at 1159. This is a weakness that is common to other alternate theories of recovery as well, such as conspiracy and active participation in a breach.

129 *In re* USACafes, L.P. Litig., 600 A.2d 43, 49 (Del. Ch. 1991). Chancellor Allen opined that director liability should still attach to the partnership's benefit in such a situation. *Id.*

130 *In re* Harwood, 637 F.3d 615, 617 (5th Cir. 2011).

did so under the belief that the loans were secured.[131] Though the case involved a defalcation finding[132] under bankruptcy law, had the limited partners attempted to sue Harwood under an aiding and abetting theory, it would first have to be shown that the granting of loans was in breach of a fiduciary duty. While this would be possible, given the broad discretion granted under the business judgment rule and the ability to rely upon information provided by officers in formulating an opinion, such a result is far from certain.[133]

B. Piercing the Corporate Veil

Piercing the corporate veil is another equitable theory frequently asserted by plaintiffs to attach liability to the owners of a corporation for the wrongs suffered at the hands of the corporation when the assets of the corporation are insufficient to make the plaintiff whole.[134] Piercing permits a plaintiff to ignore the shield of limited liability that the corporate form provides to go directly after the corporation's owner(s) (though rarely against directors).[135] Though the term "corporate" is used, the theory can generally be used to pierce limited partnerships and limited liability companies as well.[136] It is said that this equitable remedy should be imposed to avoid injustice, but as professor Gevurtz has noted,

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[131] *Id.* at 617–18.

[132] This fact adds another limit to aiding and abetting as a theory of recovery as defalcation requires a breach of a fiduciary duty.

[133] *See* Brehm v. Eisner, 746 A.2d 244, 261 (Del. 2000) ("The [Board of Directors] is entitled to the presumption that it exercised proper business judgment, including proper reliance on the expert." (footnote omitted)).

[134] *See* Cathy S. Krendl & James R. Krendl, *Piercing the Corporate Veil: Focusing the Inquiry*, 55 DENV. L.J. 1, 2, 7 (1978); Peter B. Oh, *Veil-Piercing Unbound*, 93 B.U. L. REV. 89, 90–94 (2013).

[135] *See* DeWitt Truck Brokers, Inc. v. W. Ray Flemming Fruit Co., 540 F.2d 681, 683 (4th Cir. 1976); GEVURTZ, *supra* note 100, § 1.5. The instances in which piercing has been used to impose liability on officers or directors appear to involve cases where they were also shareholders. *See* RICHARD D. FREER & DOUGLAS K. MOLL, PRINCIPLES OF BUSINESS ORGANIZATIONS 329 n.64 (2013) ("Some cases speak of imposing liability on individual officers or directors, but it appears that the defendants were shareholders as well.").

[136] *See* 51 AM. JUR. 2D *Limited Liability Companies* § 20 (2011) ("[T]he general view is that it is possible to 'pierce the veil' of a limited liability company."); 30 AM. JUR. 3D *Proof of Facts* § 4 (1995) ("The circumstances under which a limited partner may be liable to third parties is similar to that principle of corporate law called 'piercing the corporate veil.' In fact, many courts draw upon case law concerning corporations in deciding limited partner litigation.") *But see* Prospect Energy Corp. v. Dallas Gas Partners, LP, 761 F. Supp. 2d 579, 592 n.11, 602 & n.23 (S.D. Tex. 2011) (applying Texas law and noting Texas does not recognize piercing claims to reach limited partners in an LP, but that Texas does recognize piercing in the LLC context); Seidler v. Morgan, 277 S.W.3d 549, 558 n.5 (Tex. App. 2009); Pinebrook Props Ltd. v. Brookhaven Lake Prop. Owners Ass'n., 77 S.W.3d 487, 499 (Tex. App. 2002).

"[t]he problem . . . is to go beyond this broad generality and determine what specific facts establish such an injustice, and why."[137]

Frequently, courts claim that piercing will be appropriate if the corporate form is used to perpetuate a fraud, or if it is the mere "alter ego" of the owner.[138] In determining whether to pierce under the latter theory, courts have often formulated a number of factors to consider. *DeWitt Truck Brokers v. W. Ray Flemming Fruit Co.* provides a frequently cited list of such factors: (1) undercapitalization; (2) failure to observe corporate formalities; (3) non-payment of dividends; (4) insolvency of the corporation at the time; (5) siphoning of corporate funds by the dominant shareholder; (6) non-functioning of other officers and directors beside the defendant; (7) absence of corporate records; and (8) non-participation in corporate affairs by shareholders other than the defendant.[139] Though many of these factors are cited in piercing cases, the individual factors themselves do not all make sense.[140] Furthermore, the claimant's status as a tort victim, rather than a contract victim, would also seem to be relevant.[141] Contract claimants enter into transactions with the defendant willingly and have a greater ability to judge the risk of dealing

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[137] GEVURTZ, *supra* note 100, § 1.5.1. *See also* 18 AM. JUR. 2D *Corporations* § 57 (2004) ("The corporate entity generally is disregarded where it is used as a cloak or cover for fraud or illegality, to work an injustice, to defend crime, or to defeat an overriding public policy, or where necessary to achieve equity." (footnotes omitted)).

[138] *See, e.g.*, Williamson v. Recovery L.P., 542 F.3d 43, 53 (2d Cir. 2008) (noting that, to pierce, the "[individual] must have used [the corporate entity] to perpetrate a fraud or have so dominated and disregarded [the corporate entity's] corporate form that [the corporate entity] primarily transacted [the individual's] personal business rather than its own corporate business" (alterations in original) (quoting Kirno Hill Corp. v. Holt, 618 F.2d 982, 985 (2nd Cir. 1980)); Itel Containers Int'l Corp. v. Atlanttrafik Express Serv. Ltd., 909 F.2d 698, 703 (2d Cir. 1990) ("[The court] allows the corporate veil to be pierced either when there is fraud or when the corporation has been used as an alter ego . . . ."); CBR Event Decorators, Inc. v. Gates, 962 N.E.2d 1276, 1281–83 (Ind. Ct. App. 2012) ("[T]he fraud or injustice alleged by a party seeking to pierce the corporate veil must be caused by, or result from, misuse of the corporate form.").

[139] 540 F.2d at 685–87; *see also* Sprint Nextel Corp. v. iPCS, Inc., Civ.A. No. 3746-VCP, 2008 WL 2737409, at *11 (Del. Ch. July 14, 2008) (listing the following factors under Delaware law: "(1) whether the company was adequately capitalized for the undertaking; (2) whether the company was solvent; (3) whether corporate formalities were observed; (4) whether the dominant shareholder siphoned company funds; and (5) whether, in general, the company simply functioned as a facade for the dominant shareholder" (quoting U.S. Bank Nat'l Ass'n v. U.S. Timberlands Klamath Falls, L.L.C., No. Civ.A. 112-N, 2005 WL 2093694, at *1 (Del. Ch. Mar. 30, 2005) (internal quotation marks omitted)).

[140] *See, e.g.*, *DeWitt*, 540 F.2d at 683; *CBR Event Decorators, Inc.*, 962 N.E.2d at 1282. For instance, the non-payment of dividends would seem to make more money available to the claimant, and thus, one would think, would militate against piercing.

[141] *See* Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036, 1058–59 (1991) (contrasting the likelihood of piercing the veil between tort and contract claimants); Peter B. Oh, *Veil-Piercing*, 89 TEX. L. REV. 81, 85–90 (2010) (expanding on Thompson's research and finding that veil-piercing is more frequent in tort than in contract claims).

with an undercapitalized corporation, while a tort victim must take the corporation as it finds it. Contract claimants also have the ability to make inquiries into corporate structure prior to entering into a transaction. Nevertheless, it is not uncommon to see a rote recital of factors to be considered when a piercing claim is made.

Many of these factors have their basis in the "Powell Rule," published in 1931, which was an attempt by Professor Frederick Powell to articulate "a veil piercing test listing the main factors used by New York courts to determine whether to pierce the veil in a parent-subsidiary context."[142] The rule has three elements: the instrumentality rule, improper purpose, and proximate causation of an injury.[143] The second and third elements require that the plaintiff prove some direct damage caused by the defendant through "a fraud, wrong, or injustice, meaning that the parent's conduct in using the subsidiary has been somehow unjust, fraudulent, or wrongful towards the plaintiff."[144] The first element, the instrumentality rule, requires that the plaintiff prove that the "subservient corporation was operated not in a legitimate fashion to serve the valid goals and purposes of that corporation but that it functioned under the domination and control and for the purposes of some dominant party."[145] This element has been the most elusive to formulate, and is the source of many of the factors, which have been used to help courts determine if the requisite dominance, or control, is in place.[146]

This reliance on factors is part of what makes piercing, as it is currently applied, an ill fit for claimants seeking to sue second-tier managers for breach of fiduciary duties. The corporate manager is likely formed not to commit a fraud, but to perform the legitimate task of managing

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[142] Dante Figueroa, *Comparative Aspects of Piercing the Corporate Veil in the United States and Latin America*, 50 DUQ. L. REV. 683, 720 (2012); Krendl & Krendl, *supra* note 134, at 11, 15 (noting that the rule is followed "in whole or in part by most courts").

[143] Krendl & Krendl, *supra* note 134, at 15; Figueroa, *supra* note 142, at 720–21 (describing the last element as "unjust loss or injury").

[144] Figueroa, *supra* note 142, at 721 (citing Lowendahl v. Balt. & Ohio R.R. Co., 287 N.Y.S 62, 65 (N.Y. App. Div. 1936)); Krendl & Krendl, *supra* note 134, at 18–21.

[145] Krendl & Krendl, *supra* note 134, at 16; Figueroa, *supra* note 142, at 721–23.

[146] Krendl & Krendl, *supra* note 134, at 16–18. Powell formulated a list of 11 circumstances which could indicate that the subsidiary was a mere instrumentality: "(1) ownership of all or most of the stock of the subsidiary by the parent; (2) a common board and/or management and financing of the subsidiary; (3) exclusive capital subscription by the parent or incorporation of the subsidiary by the parent; (4) grossly inadequate capital of the subsidiary; (5) payment of expenses or losses, including salaries, by the parent; (6) no substantial, independent business of the subsidiary except with the parent; (7) assets wholly contributed by the parent; (8) description of the subsidiary in the parent's internal documentation as a unit thereof or description of its business or financial responsibilities as the parent's own; (9) use of the subsidiary's property as if owned by the parent; (10) a lack of independence of the subsidiary's board or management—the subsidiary is the mere executing organ of orders from and in the interest of the parent; (11) and a lack of observance of formalities for constitution of the subsidiary." Figueroa, *supra* note 142, at 722–23; Krendl & Krendl, *supra* note 134, at 16–17.

the LP or LLC. For instance, in the *Wallace* case, discussed *supra* in Part III.A, the court examined a piercing claim as an alternative theory of recovery against the managers of the corporate general partner and found that the corporation's formation to manage the LP was not enough to give rise to a piercing claim.[147] Furthermore, none of the instrumentality factors listed above may be met despite the fact that inequitable activities, such as self-dealing, are performed by the second-tier managers. This is not surprising in light of the fact that, historically, piercing was not needed to address internal claims of mismanagement against an entity's decision-makers because those decision-makers, in the corporate context, were the board of directors, which would consist of natural persons.[148] In other words, the factors were not formulated to address this type of scenario.

To demonstrate this point, consider the *USACafes* decision. There, a corporate general partner had two shareholders who also happened to sit on the board of directors along with other directors.[149] There was nothing in the facts to suggest the corporation had been formed to misappropriate funds from the LP it managed, and, by all accounts, the corporate form appeared to be respected. The other directors voted in favor of selling the LP's assets, indicating that there were functioning directors other than the shareholders.[150] Furthermore, the corporate general partner did not appear to be left insolvent as it was named as a defendant in the case and, from the facts, was alleged to have received a $1.5 million payment right from Metsa.[151] Though the opinion does not list all of the relevant facts, it seems fair to say a piercing claim, under the rubric of the traditional factors, would have been an uphill battle for the plaintiffs.

As with aiding and abetting, piercing the corporate veil may, in some instances, be available to reach managers of a corporate general partner. However, avoiding liability under this theory is easy for most savvy corporate managers who can simply make certain that the corporate general partner is adequately funded at the out-set, observe corporate formalities, and otherwise respect the corporate form. This theory does little to help the sort of self-dealing, described in the previous discussion, where a corporate manager seeks to personally take advantage of an LP opportunity. Furthermore, there is some question as to whether traditional piercing

[147] Wallace *ex rel.* Cencom Cable Income Partners II, Inc. v. Wood, 752 A.2d 1175, 1184 (Del. Ch. 1999) ("Plaintiffs merely state that the purpose of the General Partner is to manage and operate the Partnership. Plaintiffs have not stated sufficient facts that if true would justify disregarding the corporate form of the General Partner.").

[148] Feeley v. NHAOCG, LLC, 62 A.3d 649, 667–68 (Del. Ch. 2012) ("In the corporate context . . . [piercing] has been unnecessary. The authority and concomitant duty to manage a Delaware corporation rests with the board of directors. The members of a board of directors of a Delaware corporation must be natural persons." (citations omitted)).

[149] *In re* USACafes, L.P. Litig., 600 A.2d 43, 45–46 (Del. Ch. 1991).

[150] *Id.* at 46.

[151] *Id.*

can reach non-shareholder officers and directors,[152] which is problematic given the likelihood that the directors may be comprised, at least in some part, of non-shareholder directors. For instance, in *USACafes*, only the Wyly brothers were shareholders in the corporate general partner, but other directors had taken kickbacks as well.[153] If traditional piercing cannot reach such actors, this is a major limitation in its application to second-tier managers.

C. *Common Law Fiduciary Duties*

Another possible explanation for the imposition of fiduciary duties upon second-tier managers is to simply look to the common law. Generally fiduciary duties arise in two circumstances: (1) by law, such as through a particular relationship governed by statute (e.g., a partner in a partnership), or via a contract (attorney/client, principal/agent, etc.); or (2) by case law as a result of the factual circumstances underlying the relationship of the parties and the transaction at issue.[154] Those in the second category are sometimes referred to as "confidential relationships."[155] As the second-tier manager does not owe a duty via statute or contract, the relationship would have to fall into the "confidential relationship" category for a duty to attach. Identifying when such a relationship exists is not, however, an easy matter.

Many scholars have opined on the nature of fiduciary duties and offered justifications as to when and why they should apply.[156] Professor Tamar Frankel has noted that "all definitions [of fiduciaries] share three main elements: (1) entrustment of property or power, (2) entrustors' trust of fiduciaries, and (3) risk to the entrustors emanating from the entrustment."[157] Professor D. Gordon Smith has put forward a "critical resource theory" under which a fiduciary relationship arises "when one par-

[152] *See* FREER & MOLL, *supra* note 135, at 329 n.64.

[153] *In re USACafes,* 600 A.2d at 45–46.

[154] D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1412–13 (2002) ("Many courts sensibly divide the universe of fiduciary relationships into two parts: 'formal' fiduciary relationships and 'informal' fiduciary relationships. Formal fiduciary relationships are those well-settled cases—such as trustee-beneficiary, guardian-ward, partner-partner, director-shareholder, and attorney-client—where fiduciary duties apply as a matter of course. Informal fiduciary relationships—often referred to as 'confidential relationships'—are those in which the court imposes fiduciary duties based on a qualitative evaluation of the relationship." (footnotes omitted)).

[155] *See* Meadows v. Hartford Life Ins. Co., 492 F.3d 634, 639 (5th Cir. 2007) ("Texas courts characterize confidential relationships as informal fiduciary relationships that may arise 'where one person trusts in and relies on another, whether the relation is a moral, social, domestic, or purely personal one.'" (quoting Schlumberger v. Tech. Corp. v. Swanson, 959 S.W.2d 171, 176 (Tex. 1997))).

[156] *See* Julian Velasco, *Fiduciary Duties and Fiduciary Outs*, 21 GEO. MASON L. REV. 157, 161 (2013) (summarizing various scholars' formulations).

[157] TAMAR FRANKEL, FIDUCIARY LAW 4 (2011).

ty . . . acts on behalf of another party. . . while exercising discretion with respect to a critical resource belonging to the beneficiary."[158] In a very recent article, Professor Julian Velasco summarized the various approaches put forward by a number of professors by opining that "[a]t its core, a fiduciary relationship is one in which one party—the fiduciary—is trusted with power over the interests of another—the beneficiary—who becomes vulnerable as a result."[159]

Courts have similarly attempted to find common characteristics that help define when a fiduciary relationship arises. Professor Smith has observed, "While courts use various formulations to describe informal fiduciary relationships, the common elements are quite simple: (1) 'trust' or 'confidence' reposed by one person in another; and (2) the resulting 'domination,' 'superiority,' or 'undue influence' of the other."[160] These broad principles are consistent with the law in jurisdictions discussed above, such as Delaware, Texas, and Illinois. Delaware courts find that a fiduciary duty arises "where one person reposes special trust in and reliance on the judgment of another or where a special duty exists on the part of one person to protect the interests of another."[161] Texas courts have held that a fiduciary duty may arise "where one person trusts in and relies on another, whether the relation is a moral, social, domestic, or purely personal one."[162] Similarly, Illinois courts have held that "[a] fiduciary relationship exists 'where confidence is reposed on one side and resulting superiority and influence is found on the other.'"[163]

Under such broad principles, common law fiduciary duties would appear to be the ideal fit for the situation where a limited partner or LLC member seeks to sue the second-tier manager. The second-tier manager is entrusted with control over the assets of the LP or LLC via the corporate general partner or manager, and this control places the owners in a position of vulnerability as to the discretion exercised by these second-tier managers. However, though the confidential relationships are described in broad terms, in practice, courts frequently take a much narrower view of when such a relationship exists, particularly in a business

[158] Smith, *supra* note 154, at 1402 (emphasis omitted).

[159] Velasco, *supra* note 156, at 161.

[160] Smith, *supra* note 154, at 1413–14 (footnotes omitted).

[161] Auriga Capital Corp. v. Gatz Props., LLC, 40 A.3d 839, 850 (Del. Ch. 2012) (quoting Metro Ambulance, Inc. v. E. Med. Billing, Inc., Civ. A. No. 13929, 1995 WL 409015, at *2 (Del. Ch. July 5, 1995)). *See also In re* USACafes, L.P. Litig., 600 A.2d 43, 48 (Del. Ch. 1991); Cheese Shop Int'l, Inc. v. Steele, 303 A.2d 689, 690 (Del. Ch.), *rev'd on other grounds*, 311 A.2d 870 (Del. 1973).

[162] Schlumberger Tech. Corp. v. Swanson, 959 S.W.2d 171, 176 (Tex. 1997) (citing Thigpen v. Locke, 363 S.W.2d 247, 253 (Tex. 1962)).

[163] Rousonelos v. Leach, No. 4-13-0268, 2013 WL 5972197, at *10 (Ill. App. Nov. 7, 2013) (quoting Herbolsheimer v. Herbolsheimer, 328 N.E.2d 529, 530 (Ill. 1975)). *See also* Autotech Tech. Ltd. P'ship v. Automationdirect.com, 471 F.3d 745, 748 (7th Cir. 2006) (applying Illinois law).

context.[164] For instance, the Texas Supreme Court has taken a cautious approach to finding such duties in a business setting stating:

> [N]ot every relationship involving a high degree of trust and confidence rises to the stature of a fiduciary relationship. In order to give full force to contracts, we do not create such a relationship lightly. Accordingly, while 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.[165]

Delaware has similarly held that such a relationship will only arise where the relationship is "special" and does not arise in typical "arms-length" transactions.[166]

This approach, in which the broad principles that are to be served say one thing, but the application in a business setting require another, places the common law imposition of fiduciary duty law on strange footing. On the one hand, the situation in which a limited partner or member of an LLC has placed trust and control into the hands of the second-tier manager seems to fit the traditional notion of when a fiduciary duty should arise. Indeed, fiduciary duties were, in part, a response to the recognition of the dangers that could arise "where the legal ownership of property was separated from the equitable interest held by the beneficiary or true owner."[167] However, the situation arises via contract in a business setting, and though the general partner or manager owes fiduciary duties, it can be said that the limited partner or member should know that, due to the structure, no further fiduciary duty is owed by the

[164] *See Rousonelos*, 2013 WL 5972197, at *10 ("Trust and confidence are special, and create a fiduciary relationship, only if they enable the dominant party to influence or control the subservient party's decisions or behavior."); *see also* Vargas v. Esquire, Inc., 166 F.2d 651, 653–54 (7th Cir. 1948) ("But belief in the honesty and integrity of a close and intimate friend, or the existence of an employee-employer relationship, or debtor-creditor relationship, or trust alone, is not sufficient to establish the relationship." (citations omitted)). *But see* Tully v. McLean, 948 N.E.2d 714, 740 (Ill. App. 2011) (noting that, though "[n]ormal trust between contracting parties does not turn a contractual relationship into a fiduciary one," where plaintiff handed management of its sole asset over to defendant to manage, the trial court did not err in finding a fiduciary duty existed).

[165] *Schlumberger Tech. Corp.*, 959 S.W.2d at 176–77 (citations omitted); *Accord* Sallee v. Fort Knox Nat'l Bank, N.A., 286 F.3d 878, 892 (6th Cir. 2002) ("To make out a claim that a fiduciary relationship existed, the party claiming the fiduciary relationship must first show the relationship existed before the transaction that is the subject of the action."); *see also* Transp. Ins. Co. v. Faircloth, 898 S.W.2d 269, 280 (Tex. 1995); Lindley v. McKnight, 349 S.W.3d 113, 124–25 (Tex. App.—Fort Worth 2011, no pet.).

[166] Total Care Physicians, P.A. v. O'Hara, 798 A.2d 1043, 1058 (Del. Super. Ct. 2001) (internal quotation marks omitted).

[167] *Id.*; *see also* FRANKEL, *supra* note157; Smith, *supra* note 154, at 1412–14.

second-tier manager except in extraordinary circumstances.[168] Thus, given the business context, it is unlikely a fiduciary duty will arise due to a confidential relationship between the limited partners or members and second-tier managers.

Not only does the applicability of common law fiduciary duties seem questionable in practice, it is also a poor fit due to the conflict it creates with regard to the dual duties a second-tier manager would then owe. In other words, even assuming that common law fiduciary duties could be expanded to apply to second-tier managers, this does not help answer the question of which party—the corporate general partner (or manager) or the limited partner (or member)—is owed the superior duty? Furthermore, imposition of such a duty would seemingly entail all of the fiduciary duties, including a duty of care, which Delaware courts have thus far rejected in the second-tier manager context.[169]

V. A NEW EQUITABLE THEORY

In reviewing the cases that have dealt with the issue of whether to assign fiduciary duties to second-tier managers, three concerns can be identified: structure, scope, and policy. The "structural" concern involves the inherent problem of assigning liability to a manager, when the true duty lies with the corporate general partner or corporate manager. Illinois has apparently dealt with this concern by simply rejecting *USACafes* and only assigning liability under other equitable theories such as piercing.[170] The "scope" concern is with regard to whether, assuming some form of duty does apply, the full range of fiduciary duties should apply to second-tier managers. Delaware has thus far limited the scope to claims involving self-dealing at the limited partners' expense, but Texas has articulated no such limit. The final concern, policy, involves the potential Catch-22 a second-tier manager will find themselves in, if fiduciary duties are owed to both the corporate general partner and the limited partners or members of an LLC.[171] Professor Hamilton advocates that in such situations, the limited partners' interests must trump, but, as discussed *su-*

[168] *See* Gotham Partners, L.P. v. Hallwood Realty Partners, L.P., No. CIV.A.15754, 2000 WL 1476663, at *20 (Del. Ch. Sept. 27, 2000) ("After all, [the corporate general partner] is the entity that the limited partners agreed would manage their assets.").

[169] *See* Feeley v. NHAOCG, LLC, 62 A.3d 649, 671–72 (Del. Ch. 2012).

[170] *See* 1515 N. Wells, L.P. v. 1513 N. Wells, L.L.C., 913 N.E.2d 1, 10 (Ill. App. 2009) ("Illinois has not adopted the view taken in *USACafes.* In Illinois, a corporation is 'an entity separate and distinct from its officers, shareholders, and directors, and those parties will not be held personally liable for the corporation's debts and obligations.'" (quoting Tower Investors, LLC v. 111 East Chestnut Consultants, Inc., 864 N.E.2d 927, 941 (Ill. App. Ct. 2007)).

[171] *See Gotham Partners, L.P.*, 2000 WL 1476663, at *20.

pra,[172] his reasoning has some flaws, and Delaware courts certainly remain cautious of such a situation.[173]

It is tempting to simply rely on existing equitable remedies to address these concerns. However, though alternate doctrines such as aiding and abetting and piercing can reach some bad actors, they are inadequate to respond to the particular problems of multi-tier fiduciary responsibility and consequent inequitable situations. Common law application of fiduciary duties, though steeped in equitable language, likewise, faces an application problem. Furthermore, none of the three doctrines fully address the concerns raised by attaching fiduciary duties while simultaneously balancing the types of inequitable conduct to which courts wish to attach liability. In short, what is needed is a new theory.

This Article advocates for a new approach with a starting assumption that no liability attaches to second-tier managers. This is the opposite of Professor Hamilton's position that duties owed to the limited partners should trump duties owed to the corporate manager. However, just as in piercing the corporate veil, there are certain equitable circumstances that would justify the imposition of liability. The remainder of this Article argues that courts should address claims for attaching liability to second-tier managers as simply a sub-species or limited form of piercing.[174] Unlike traditional piercing the corporate veil claims, the relevant factors will look toward issues of abuse of control rather than abuse of the corporate form. As such, courts should address three primary questions in deciding whether pierce—(1) was the defendant in control of the asset?; (2) was there a breach of a fiduciary duty alleged?; and (3) can the second-tier managers' conduct be explained primarily on the basis of a good faith effort to comply with a duty owed to the corporate general partner?[175] These inquiries will allow fiduciary liability to attach to a broader array of circumstances than the current Delaware or strict-traditional approaches would allow, but still reign in the cause of action to account for the dual role second-tier managers play.

[172] *See supra* notes 97–102 and accompanying text.

[173] *See, e.g.*, Bay Center Apartments Owner, LLC v. Emery Bay PKI, LLC, C.A. No. 3658-VCS, 2009 WL 1124451, at *9 n.44 (Del. Ch. Apr. 20, 2009) (noting that *USACafes* raises difficult policy issues); Gelfman v. Weeden Investors, L.P., 792 A.2d 977, 992 (Del. Ch. 2001) (noting the "awkward position occupied by directors of corporate General Partners"); *Gotham Partners, L.P.*, 2000 WL 1476663, at *22 (noting that directors on the board of a general partner potentially expose themselves to claims of breach of the duty of loyalty whenever they make a "good-faith decision about a transaction between the partnership and an affiliate of the general partner").

[174] At least one court has hinted that this is, in essence, what the *USACafes* approach does. *Bay Center Apartments Owner, LLC*, 2009 WL 1124451, at *9 & n.44 (noting that the *USACafes* approach "disregards corporate formalities in a manner unusual for Delaware law").

[175] This last inquiry is important as, even if it is conceded that the defendant had control of the asset and that there is an allegation of breach of duty, the second-tier manager's conduct will not give rise to liability if it is a consequence of a good faith effort to comply with a duty owed to the manager/entity.

Before delving into each of these questions, an explanation of this new form of limited piercing, which I will refer to as piercing the fiduciary veil,[176] is in order. In each of the cases in which a court has assigned a fiduciary duty, the court has faced the troubling prospect of permitting inequitable conduct by the party that controls the general partner entity. This is a prospect that is somewhat unique to the set-up of a limited liability entity that is itself managed by a limited liability entity.[177] The construct of the corporate general partner ends up insulating its directors, not only from liability to third parties, but also from liability to the limited partners and members in the managed LP or LLC.[178] In a corporate setting, this concern does not exist, because the directors must be natural persons; thus, the issue of who owes fiduciary duties is much clearer. However, stating that a corporation itself owes a fiduciary duty is akin to saying the Jewish Golem of myth owes a duty.[179] The Golem only does what it is told, and so you must look to the person or persons controlling the Golem if you want to affect its behavior. As two commentators have aptly noted:

> A corporation is managed by its board of directors, which must be filled with natural persons. An LP, on the other hand, is managed by a general partner, which may be a corporate entity. *USACafes* appears to be motivated by the desire to break through the corporate skin and attach liability—in an appropriate circumstance—to the actual individuals, the natural persons, responsible for wrongdoing. In the corporate context, those individuals are easy to spot: they serve on the corporation's board of directors. In the context of

[176] The name is somewhat misleading in that it is still the corporate veil that is being pierced, but for the purpose of attaching a fiduciary duty.

[177] An analogy could be made to corporate majority parent companies and the duties owed to subsidiary minority shareholders. *See* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971). In such situations, courts have held there is a duty not to force the subsidiary to give an economic advantage to the parent at the minority shareholders' expense, subject to an intrinsic fairness standard. *Id.* "A parent does indeed owe a fiduciary duty to its subsidiary when there are parent-subsidiary dealings. However, this alone will not evoke the intrinsic fairness standard. This standard will be applied only when the fiduciary duty is accompanied by self-dealing—the situation when a parent is on both sides of a transaction with its subsidiary. Self-dealing occurs when the parent, by virtue of its domination of the subsidiary, causes the subsidiary to act in such a way that the parent receives something from the subsidiary to the exclusion of, and detriment to, the minority stockholders of the subsidiary." *Id. See also* Harriman v. E. I. Du Pont De Nemours and Co., 411 F. Supp. 133, 152 (D. Del. 1975) (citing *Sinclair*, but finding lack of majority ownership prevented the application of the rule); Tooley v. AXA Fin., Inc., No. 18414, 2005 WL 1252378, at *6 (Del. Ch. May 13, 2005) (applying *Sinclair* to find plaintiffs pled sufficient facts to withstand dismissal).

[178] This is even more pronounced in an LLC as the manager of an LLC does not have the same individual liability to third parties as does a general partner.

[179] RALPH ESTES, TYRANNY OF THE BOTTOM LINE: WHY CORPORATIONS MAKE GOOD PEOPLE DO BAD THINGS 21 (1996); LAWRENCE E. MITCHELL, CORPORATE IRRESPONSIBILITY: AMERICA'S NEWEST EXPORT 44 (2001).

LLCs and LPs, the courts must look inside the entity serving as a fiduciary.[180]

Like traditional piercing, abuse is the concern that prompts the court to look beyond the corporate form. However, unlike traditional piercing, the abuse is not one of the corporate form but how that form is being controlled. For instance, in many of the cases in which a fiduciary duty claim has been made against second-tier managers, the corporate form itself was not being abused in the sense that it was not simply an undercapitalized corporate shell. Nor was the corporation formed to commit a fraud. The corporate form in these cases may very well be legitimately formed, follow formalities, and avoid any of the various factors courts traditionally consider in piercing claims. Notwithstanding this legitimacy, the second-tier managers may use their control over this form in such a way as to cause a court to consider whether the control entrusted to them is being abused. Thus, it only makes sense that different factors should weigh in the balance. This Article opines that the three factors, or questions, that should be considered when deciding to pierce the fiduciary veil involve control, the breach, and the justifications for the allegedly inequitable conduct. As this is a subspecies of traditional piercing the corporate veil, the fact that some of the inquiries bear a similarity to factors considered in traditional piercing claims should come as no surprise. However, the focus is shifted to account for the unique problem the structure presents in LPs and LLCs.

A. Control

Control is the *sine qua non* of fiduciary duty liability. It is the theme that permeates the cases that have assigned fiduciary duties to second-tier managers,[181] and it was the first justification offered by Chancellor Allen in *USACafes*.[182] In one sense, control is an expansive, rather than limiting,

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[180] Russell C. Silberglied & Blake Rohrbacher, TOUSA, USACafes, *and the Fiduciary Duties of a Parent's Directors upon a Subsidiary's Insolvency*, *in* NORTON ANNUAL SURVEY OF BANKRUPTCY LAW 33, 53 (William L. Norton, Jr. ed., 2011) (footnotes omitted).

[181] *In re* Harwood, 404 B.R. 366, 397 (Bankr. E.D. Tex. 2009) ("The relevant issue should not be the choice of organizational form, nor the numerosity of warm bodies available to blame in a corporate setting, but rather an analysis of whether the degree of control actually exercised by a corporate officer over the actions of a corporate general partner warrants a corresponding recognition of the fiduciary responsibilities realistically assumed by that individual as to an affected limited partnership entity. Simply stated, with control comes responsibility, and that principle is no less applicable to corporate officers controlling the actions of an inanimate corporation as a general partner of a limited partnership than it is when fiduciary duties of second-tier managing partners are recognized in a partnership setting.").

[182] *In re* USACafes, L.P. Litig., 600 A.2d 43, 48 (Del. Ch. 1991) ("I understand the principle of fiduciary duty, stated most generally, to be that one who controls property of another may not, without implied or express agreement, intentionally use that property in a way that benefits the holder of the control to the detriment of the property or its beneficial owner. . . . [T]he central aspect of the relationship is,

factor in that it permits the claimant to go straight to the party that is actually in control, regardless of the layers of corporate forms that may lie between them and the ultimate party in control.[183] Furthermore, control need not mean majority ownership; control over the particular issue in dispute is sufficient.[184] However, it is also a limiting principle in that majority shareholders or even individual directors who lack control over the LP or LLC cannot be held liable.[185] This offers a defense to passive shareholders, and even managers that may not be the party exercising control.

In re Parkcentral Global Litigation[186] offers a good example of how control can operate to bar imposition of a fiduciary duty under both Texas and Delaware law. The plaintiffs in that case were limited partners in Parkcentral Global, LP ("Parkcentral") which was formed under Delaware law with Parkcentral Capital Management, LP ("PCCM") as the

undoubtedly, fidelity in the control of property for the benefit of another."). This concept plays a similar role in traditional piercing claims, as passive investors avoid liability. *See* Robert B. Thompson, *The Limits of Liability in the New Limited Liability Entities*, 32 Wake Forest L. Rev. 1, 10 (1997) (noting that passivity is an important factor in piercing the veil and that passive investors are insulated from liability).

[183] *See* Cargill, Inc. v. JWH Special Circumstance LLC, 959 A.2d 1096, 1101–03, 1118 (Del. Ch. 2008) (finding, in case involving a statutory trust, that 100% parent and 100% grandparent of the trust's managing owner has a duty not to use its control to take advantage of the trust or its property at the expense of the trust); Bigelow/Diversified Secondary P'ship Fund 1990 v. Damson/Birtcher Partners, No. Civ.A.16630-NC, 2001 WL 1641239, at *8 & n.42 (Del. Ch. Dec. 4, 2001) ("[T]hose affiliates of a general partner who exercise control over the partnership's property may find themselves owing fiduciary duties to both the partnership and its limited partners."); Wallace *ex rel.* Cencom Cable Income Partners II, Inc. v. Wood, 752 A.2d 1175, 1182 (Del. Ch. 1999) (applying duties to parents and affiliates that control the affairs of the partnership); Barbieri v. Swing-N-Slide Corp., C.A. No. 14239, 1997 WL 55956, at *1–3 (Del. Ch. Jan. 29, 1997); James River-Pennington Inc. v. CRSS Capital, Inc., Civ. A. No. 13870, 1995 WL 106554, at *11 (Del. Ch. Mar. 6, 1995).

[184] *In re Harwood*, 637 F.3d 615, 622 (5th Cir. 2011) (concluding, in the context of a bankruptcy case, that "an officer of a corporate general partner who is entrusted with the management of the limited partnership and who exercises control over the limited partnership . . . owes a fiduciary duty to the partnership"); *cf.* A.W. Chesterton Co. v. Chesterton, 128 F.3d 1, 7–9 (1st Cir. 1997) (finding, in close corporation context, minority shareholder owed a fiduciary duty to the majority shareholders, as he had control over the issue of whether the corporation would retain its S corporation status); Rexford Rand Corp. v. Ancel, 58 F.3d 1215, 1219 n.10 (7th Cir. 1995) ("In addition, a minority shareholder owes a fiduciary duty to the corporation when his interests are controlling on a particular issue."); Smith v. Atlantic Properties, Inc., 422 N.E.2d 798, 802 n.9 (Mass. App. Ct. 1981) (explaining that, just as a majority shareholder may owe duties to the minority shareholder, "[a] minority shareholder whose conduct is controlling on a particular issue should be bound by no different standard.").

[185] *See In re* Kerry, No. 09-80766, 2012 WL 1865451, at *9 (Bankr. W.D. La. May 22, 2012) (holding the office manager did not exercise sufficient control to establish a fiduciary duty); Krendl & Krendl, *supra* note 134, at 16 (noting that for piercing, majority ownership is not enough to pierce and that the domination must be with respect to the transaction being attacked, rather than "domination in general").

[186] 884 F. Supp. 2d 464 (N.D. Tex. 2012).

general partner.[187] The plaintiffs sued, among others, the owner of PCCM, the Perot Family Trust ("PFT"), and the entity that provided management services to PCCM, Perot Investments ("PI"), claiming mismanagement and breach of fiduciary duties.[188] In determining whether each of these defendants owed a fiduciary duty, the court looked to Delaware law for PI and Texas law for PFT.[189] With regard to PI, the plaintiffs alleged that PI controlled Parkcentral through its advice, as well as through the shared management responsibilities with PCCM; however, the court held that the fact that these entities "had overlapping management teams, or even that they were fully integrated, does not give rise to an inference that [PI] exercised control over Parkcentral."[190] Turning to PFT, the court noted that Texas law also focuses upon the "*exercise* of control, rather than mere ownership or ability to control," in assigning fiduciary duties.[191] Though PFT owned PCCM, there was no evidence that PFT had any actual day-to-day responsibilities over Parkcentral, despite securities statements to the effect that PFT controlled PCCM.[192] Thus, the court concluded that "[w]hile day-to-day responsibilities may not be required, something more than what Plaintiffs have pleaded is required to establish that [PFT] *exercised* control over Parkcentral."[193]

B. Conduct That Would Breach a Fiduciary Duty

The piercing the fiduciary veil approach starts from the position that second-tier managers owe no independent fiduciary duties to the managed LPs, LLCs or their limited partners or members. In this way, the approach represents a break from *USACafes*, which articulated a limited duty owed by the second-tier managers. Instead of viewing the duty as independently owed, the duty only arises under circumstances where, in equity, the court would be justified in ignoring the corporate form. Under such a theory, it is therefore axiomatic that, to succeed on a breach of fiduciary duty claim, there must be conduct alleged that is derivative of the duties owed by the corporate general partner or manager. However, to avoid situations in which the corporate general partner is circumvented to accomplish the conduct, courts must look beyond actions that the corporate general partner is compelled to do by its managers. The taking

[187] *Id.* at 469.

[188] *Id.* at 472.

[189] *Id.* at 472, 474.

[190] *Id.* at 473.

[191] *Id.* at 474.

[192] *Id.* at 474–75.

[193] *Id.* at 475. Two officers of PCCM were also alleged to have breached a fiduciary duty based on their mismanagement. The court dismissed these claims, not on the control prong, but rather because these officers did not exercise control to benefit themselves at Parkcentral's expense as would be required under Delaware law. *Id.* at 476. However, the court held that the plaintiffs had sufficiently alleged facts to support a misrepresentation claim against these same defendants. *Id.* at 480.

of a corporate opportunity, for example, could just as easily be accomplished without the involvement of the corporate general partner, especially if such actions avoided the breach of a fiduciary duty.

To explain this further, consider the following hypothetical. Abel, LP is formed with Cain, Inc. as the general partner. John Cain is the majority shareholder of Cain, Inc. and one its three directors. Abel, LP is formed to purchase and manage rental properties. In his role as director, John Cain comes across a grossly undervalued property. Rather than have Abel, LP purchase it, he buys the property himself and manages it. Had Cain, Inc. purchased and managed the property, this would likely breach the fiduciary duty of loyalty owed to Abel, LP, but by simply keeping Cain, Inc. out of the transaction, no fiduciary duty will be breached.

Therefore, to avoid this gamesmanship, courts must consider both violations of fiduciary duties by the corporate general partner as well as conduct engaged in by second-tier managers that would be a violation if the corporate general partner were to engage in the same conduct. While this is somewhat of an expansion in scope, it will capture conduct that could otherwise avoid liability under doctrines such as aiding and abetting.

By tying the conduct to the duties owed by the corporate general partner, second-tier managers can have a sense of predictability as to what is permitted. Thus, the nature of the conduct also requires an examination of the partnership or operating agreements to determine whether the conduct at issue is contemplated or permitted. In this manner, the conduct factor may be a limiting principle, especially in jurisdictions that permit the elimination of the duties of loyalty and care, such as Delaware.[194] As, under a piercing claim, the liability is derivative of the corporate general partner, it makes little sense to permit a claim to move forward if the parties contemplated that the conduct was permissible.

C. *Lack of Good Faith Justification for Actions*

The previous two factors are restatements of principles gleaned from the case law in those cases where courts have been willing to pierce the fiduciary veil. This third factor goes further and expands slightly the field of conduct that can give rise to liability, beyond the scope of current Del-

[194] *See, e.g.*, DRULPA, DEL. CODE ANN. tit. 6, § 17-1101(d) (2013) (originally revised 1974) (permitting expansion, restriction, or elimination of fiduciary duties in limited partnerships); DEL. CODE ANN. tit. 6, § 18-1104 (2013) (originally revised 1974) (permitting expansion, restriction, or elimination of fiduciary duties in limited liability companies); Dawson v. Pittco Capital Partners, L.P., C.A. No. 3148-VCN, 2012 WL 1564805, at *16 (Del. Ch. Apr. 30, 2012) (dismissing complaint with regard to directors and officers of LLC manager where operating agreement explicitly eliminated such duties). *But see In re* Houston Regional Sports Network, L.P., 505 B.R. 468, 479–82 (Bankr. S.D. Tex. 2014) (holding that directors of a limited partnership's general partner, as the managers of the bankruptcy estate's affairs, owe fiduciary duties in bankruptcy to the estate, regardless of provisions in the partnership agreement to the contrary).

aware law, but nonetheless in a manner consistent with the cases thus far decided.[195] A primary problem with permitting second-tier managers to owe fiduciary duties is that situations could arise where such managers owe conflicting duties.[196] This factor seeks to resolve this conflict in favor of the second-tier manager who is motivated primarily by good faith. Such an approach makes sense in equity as, if the board member or officer is complying with a duty owed to the corporation, there is less of an equitable concern, and conversely courts should be less concerned with protecting a second-tier manager that is not acting primarily for the benefit of the corporation. Thus, a court should not pierce the fiduciary veil if the second-tier manager's conduct can be primarily explained based on a good faith effort to fulfill its fiduciary obligations to the corporate general partner.[197]

The good faith in this sense is referring to the motive behind the conduct and must be the primary motivating factor. This, of course, will often require a factual inquiry and evaluations of motive. A second-tier manager that has received a kick-back, but also thinks the actions he or she has taken are in the best interest of the corporate general partner, must have his or her conduct evaluated to determine whether the latter was the primary motivator, and certainly the implication under such circumstances will be negative. Similarly, a director who also happened to be the sole shareholder of the corporate general partner may have his or her actions called into question when the benefits that inure to the corporation directly benefit the shareholder at the expense of the limited partners.[198]

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[195] *See, e.g.*, Red River Wings, Inc. v. Hoot, Inc., 751 N.W.2d 206, 219 (N.D. 2008) (noting that "limited partners who participate in the business of the partnership or act in concert with the general partner are subject to the fiduciary duties of loyalty and care and the obligations of good faith and fair dealing applicable to partners in a general partnership"); Anthony v. Padmar, Inc., 465 S.E.2d 745, 752 (S.C. Ct. App. 1995) ("The scope of the fiduciary duty has been variously defined as one requiring utter good faith or honesty, loyalty or obedience, as well as candor, due care, and fair dealing.").

[196] *In re* USACafes, L.P. Litig., 600 A.2d 43, 49 (Del. Ch. 1991) ("The directors and officers are in a fiduciary relation not merely to the [corporation] . . . but to the beneficiaries of the trust administered by the [corporation]." (alterations in original) (quoting 4 AUSTIN WAKEMAN SCOTT & WILLIAM F. FRATCHER, THE LAW OF TRUSTS § 326.3 (4th ed. 1989)).

[197] *Cf.* Lill v. Cavalier Rural Elec. Coop., 456 N.W.2d 527, 530 (N.D. 1990) ("Normally, the good faith acts of corporate directors within the power of the corporation and in the exercise of honest business judgment are considered valid and the courts generally will not interfere with or regulate the conduct of the directors in the reasonable and honest exercise of their judgment and duties where their judgment is uninfluenced by personal consideration.").

[198] *See* Welch v. Via Christi Health Partners, Inc., 133 P.3d 122, 141–42 (Kan. 2006) (examining the motives of a majority partner who merged the partnership with a limited liability company to his benefit and to the detriment of the limited partners).

D. *Piercing the Fiduciary Veil in Action*

Recognition of piercing the fiduciary veil addresses, if not completely resolves, the concerns addressed at the beginning of Part V, *supra*. The structural concern is resolved in favor of continuing to recognize the corporate general partner as a separate entity except in those circumstances where equity permits looking behind the corporate form.[199] This offers at least as much respect to the corporate form as is recognized currently where the corporate form can be pierced under traditional standards. The scope and dueling duty concerns are addressed by the third factor, which looks at the motivations of the alleged bad actor. The dueling duties concern is resolved in favor of the good faith actor. With regard to scope, though theoretically this approach leaves the full range of duties intact, in practice it would be difficult to bring a successful duty of care action unless the second-tier manager completely failed to act. Thus, claims for corporate waste might still be available.

For instance, if the second-tier managers were to cause a limited partnership to lose money through neglect, such as by completely failing to pay attention to his or her duties, it would be unlikely that such neglect could be explained as being primarily motivated by a good faith effort to fulfill the duties owed to the corporate general partner. This theory can reach other claims as well, however, such as failure to monitor claims,[200] and taking of a corporate opportunity claims.[201] But in each of these instances the plaintiff will still carry the burden of showing that a breach has occurred. In essence, breaching the fiduciary veil adds an extra inquiry into the motives of the second-tier managers.

Piercing the fiduciary veil also offers a consistent basis for attaching liability and explains the results in multiple decisions where liability has attached to second-tier managers. For instance, in the *USACafes* case, the owners and directors had control over the decision to sell the partner-

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[199] *See* United States v. Milwaukee Refrigerator Transit Co., 142 F. 247, 255 (C.C.E.D. Wis. 1905) ("[A] corporation will be looked upon as a legal entity as a general rule, and until sufficient reason to the contrary appears; but, when the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud, or defend crime, the law will regard the corporation as an association of persons.").

[200] *See In re* Syncor ERISA Litig., 351 F. Supp. 2d 970, 986 (C.D. Cal. 2004) ("The Department of Labor's regulations describe the duty to monitor as follows: [a]t reasonable intervals the performance of trustees and other fiduciaries should be reviewed by the appointing fiduciary in such manner as may be reasonably expected to ensure that their performance has been in compliance with the terms of the plan and statutory standards, and satisfies the needs of the plan." (quoting 29 C.F.R. § 2509.75-8) (2013)).

[201] *See* Broz v. Cellular Info. Sys., Inc., 673 A.2d 148, 154–55 (Del. 1996) ("The corporate opportunity doctrine . . . holds that a corporate officer or director may not take a business opportunity for his own if: (1) the corporation is financially able to exploit the opportunity; (2) the opportunity is within the corporation's line of business; (3) the corporation has an interest or expectancy in the opportunity; and (4) by taking the opportunity for his own, the corporate fiduciary will thereby be placed in a position inimicable to his duties to the corporation.").

ship assets to Metsa, meeting the first prong.[202] The conduct alleged would have violated the duty of loyalty had the corporate general partner engaged in the transaction, i.e. had the corporation itself accepted a kick-back to sell the limited partnerships assets at an undervalued price, thus satisfying the second prong. Finally, the third prong would likely also be satisfied, as the acceptance of side payments on the part of the directors would call into the question whether the transaction was primarily being entered into for the benefit of the corporate general partner rather than for themselves.

Similarly, the *Harwood* decision could be examined under this new piercing approach to reach the same result as the court. Harwood had been entrusted with control over the transactions at issue, i.e. obtaining loans from the limited partnership to himself.[203] Had the corporate general partner itself obtained the loans in the amount and manner that Harwood had done, it would have violated the duty of loyalty owed to the partnership, thus satisfying the second prong. Finally, the loans did not appear to serve any purpose that would benefit the corporate general partner to whom the actual duty was owed, satisfying the third prong.

Though there may be some variations and closer cases,[204] overall, this piercing the fiduciary approach would explain most of the cases thus decided where liability has attached to second-tier managers. It also is more flexible that the current limited duty approach of Delaware, but gives more guidance than the pure "control" approach of Texas. Furthermore, it permits the possibility of attaching liability to second-tier managers in the future in situations that have yet to be addressed adequately through existing cases.

VI. CONCLUSION

The question of whether second-tier managers should owe fiduciary duties to the limited partners and members of the LPs and LLCs they control has persisted for more than twenty years. The rapid growth of LLCs as a preferred business form over alternatives such as close corporations will likely accelerate the frequency with which the question is before courts. Current responses have run the spectrum from the Illinois approach, which does not recognize a duty, to the Texas approach, which attaches fiduciary duties to those in control, with the Delaware approach falling somewhere in the middle, recognizing limited duties. The Illinois approach, with its rigid adherence to a traditional conception of the

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[202] *In re* USACafes, L.P. Litig., 600 A.2d 43, 45–46, 49–50 (Del. Ch. 1991).

[203] *In re* Harwood, 637 F.3d 615, 617–18 (5th Cir. 2011).

[204] For instance, though this approach would adequately explain the attachment of liability to Carpenter in the *McBeth* case, the necessary control might have been lacking to reach the other limited partners TWS and TWM. However, the court there was applying the Texas "control" approach and upheld the jury finding that TWS and TWM exerted control through the shared management of Carpenter. McBeth v. Carpenter, 565 F.3d 171, 179 (5th Cir. 2009).

structure of LPs and LLCs with second-tier managers limits courts' abilities to address serious abuses by such managers, unless the abuses run afoul of another recognized theory of recovery, such as piercing. The decisions of the courts that recognize fiduciary duties have given little guidance on the basis for the decision to attach liability, other than to point to control as a justification, leaving questions as to the scope of such duties as well as how to resolve conflicts between dueling duties. Though alternate equitable theories exist that could reach the same conduct, as they currently are applied, such theories fall short; theories such as aiding and abetting cannot reach certain types of conduct, and theories such as piercing the corporate veil and common law imposition of fiduciary duties have not been applied, thus far, in such a fashion to reach second-tier managers in many situations.

The solution is to reexamine what courts are doing when they attach fiduciary duties to second-tier managers. Essentially courts are stripping back the corporate form to reach the true party in control. This is a form of piercing the corporate veil, but for the limited purpose of attaching fiduciary duties. Just as with traditional piercing, control is a key aspect, but unlike traditional piercing, which concerns itself with abuse of the corporate form, the concern in piercing the fiduciary veil is the abuse of the control. Though courts have not always spoken in such terms, a review of the cases where courts have pierced the fiduciary veil reveals that an abuse of control is the common thread. From *USACafes*, which involved accepting kickbacks to enter into a transaction unfavorable to the limited partners, to *Harwood*, which involved self-dealing loans, abuse of the control was a key element to attaching a fiduciary duty. But judging what actions are an abuse is difficult, and the term should not be limited to only self-dealing transactions; nor should all self-dealing transactions be viewed as an abuse. The better measure is to judge the motivations behind the conduct under a good faith standard. If a second-tier manager can be said to have acted primarily out of a good faith effort to meet the duties owed to the corporate general partner, then no liability should attach.

Such an approach, recognizing the ability to pierce when there has been an abuse of control, addresses the three concerns that have traditionally arisen when courts have been faced with whether to apply fiduciary duties to second-tier managers. The structural aspect, though not protected in absolute terms, is at least respected to the same degree that is already recognized, where the corporate form is respected absent circumstances that justify piercing. The scope and conflicting duties concerns are also addressed as limiting piercing to only those cases involving an abuse of control will necessarily limit the types of claims brought and resolve conflicts in favor of the good faith actor. Such an approach will also add a degree of predictability to what has, for more than twenty years now, been a murky area of law.