Opinion issued December 20, 2018

In The

Court of Appeals

For The

First District of Texas

NO. 01-17-00865-CV

DANIAL E. LEE AND STANLEY M. LEE, Appellants

V.

GLOBAL STAINLESS SUPPLY, INC. AND FORGINGS, FLANGES & FITTINGS, LLC, Appellees

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On Appeal from the 157th District Court
Harris County, Texas
Trial Court Case No. 2015-49554

MEMORANDUM OPINION

This summary-judgment appeal involves a business dispute between, on the one side, Danial E. Lee and Stanley M. Lee (the "Lees") and, on the other side, Global Stainless Supply, Inc. ("Global") and Forgings, Flanges & Fittings, LLC, a Delaware limited liability company (the "LLC"). The Lees, who held minority

interests in the LLC, sued the LLC and Global (the LLC's majority-interest holder and manager), alleging that Global had breached the parties' agreements by forcing the sale of the Lees' membership interests for a negative purchase price and by refusing to make distributions to the Lees of more than $6 million. Global responded that the Lees' suit is an attempt to get a new deal after the LLC's declining financial performance left them empty-handed.

In four issues on appeal, the Lees contend that fact issues precluded summary judgment on their claims against Global and the LLC for breach of contracts, noncompliance with Delaware's implied covenant of good faith and fair dealing, and Delaware statutory violations. We affirm.

Background

The Lees and Global go into business together

In 1983, Danial Lee and a German supplier founded Forgings, Flanges & Fittings, L.P., a master distributor of carbon steel products to the oil-and-gas industry. Danial's brother, Stanley Lee, worked for the business from nearly its inception, and eventually the two brothers became the majority owners. In 2006, the Lees capitalized on their business's success and sold its assets to the LLC—a new entity Global formed under Delaware law—for more than $15 million. Global, a wholly owned subsidiary of Sumitomo Corporation of Americas ("Sumitomo"), already was a master distributor of stainless steel products to the oil-and-gas

industry. Global's acquisition of the Lees' business positioned the newly formed LLC to supply a greater variety of steel products and capture additional market share.

The LLC Agreement and the Put/Call Agreement

As part of the transaction for the purchase and sale of the Lees' business, the parties, in 2006, executed two agreements that are the primary subjects of this appeal: (1) the Limited Liability Company Agreement of Forgings, Flanges & Fittings, LLC (the "LLC Agreement") between the Lees and Global, and (2) the Put/Call and Members' Agreement (the "Put/Call Agreement") between the Lees, Global, and the LLC.[1]

The LLC Agreement authorizes two classes of membership interests—voting and nonvoting—and assigns Global an 85% voting interest and the Lees each a 7.5% nonvoting interest. Although the Lees were hired to "run the [c]ompany," the LLC Agreement did not confer them with any special authority to participate in the LLC's management beyond their role as executives. The LLC Agreement provided that Global would serve as the LLC's manager.

The LLC Agreement initially provided in Section 9 for two types of distributions—(1) pro-rata distributions of Net Cash Flow[2] and (2) distributions to

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[1] The Lees also entered into employment agreements with the LLC, but the employment agreements are not at issue on appeal.

[2] "'Net Cash Flow' means for any period of the amount equal to (a) all cash received by the Company, plus (b) any amounts released from Reserves by the Manager (c) the Company's overall net operating expenses, including indebtedness required or

cover estimated tax liabilities—that "shall be paid at such time as determined by the Manager; provided that minimum distributions shall be made each year to the Members in amounts equal to the taxes accruing on their allocable portion of any profits of the Partnership prior to the date such taxes become due and payable." However, the LLC Agreement was amended in 2014 to "clarify the methodology to be used to calculate minimum distributions." As amended, Section 9 required that tax-liability distributions "be made quarterly." The language regarding the other type of distribution, of Net Cash Flow, remained substantially the same as in the original 2006 LLC Agreement.

The Put/Call Agreement sets forth additional aspects of the parties' business relationship and the terms for Global to purchase the Lees' membership interests. Described generally, a "put" option allows a departing party to require the counterparty to buy his interest according to a predetermined price or calculation, whereas a "call" option allows one party to force the sale of the other party's interest.

By their agreement, the parties granted a "put" option to the Lees and a "call" option to Global. In the event Global terminated the Lees' employment without cause and exercised its call option later than the LLC's third anniversary, the price

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elected to be made in connection with any refinancing, sale or other event, less (d) any increase in Reserves by the Manager." The parties agree that the word "less" was omitted from this definition before subpart (c) and should be read into the definition so that Net Cash Flow is "[less] (c) the Company's overall net operating expenses, . . . less (d) any increase in Reserves by the Manager."

for the Lees' membership interests would be determined using a formula based on the LLC's EBITDA[3] and Net Debt[4] at a particular date (the "Determination Date").[5] The agreed-to Formula Price is "((EBITDA × 4) – N) × I))."[6]

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[3] "'EBITDA' shall mean profit before interest, taxation, depreciation and amortization, as adjusted for exceptional, extraordinary and non-recurring items, as shown in the audited accounts of the [LLC] prepared in accordance with U.S. GAAP [Generally Accepted Accounting Principles]."

[4] "'Net Debt' shall mean (a) (i) all of the [LLC's] obligations for borrowed money, (ii) all obligations of the [LLC] evidenced by bonds, debentures, notes, or other similar instruments, (iii) all obligations of the [LLC] to pay the deferred purchase price of property or services, except trade accounts payable arising in the ordinary course of business, (iv) all obligations of the [LLC] as lessee which are capitalized in accordance with generally accepted accounting principles, (v) all obligations secured by a lien on any asset of the [LLC], whether or not such obligations are otherwise obligations of the [LLC] and (vi) all obligations of others Guaranteed by the [LLC], minus (b) the [LLC's] cash and cash equivalents as of the Determination Date, in each of cases (a) and (b) as shown in the audited accounts of the [LLC] prepared pursuant to Section 2.3(c) or 3.3(b) in accordance with U.S. GAAP."

[5] The "Determination Date" for exercise of a call option after the Lees' termination (other than for cause) is established as at "the last day of the calendar quarter immediately preceding the applicable Call Date." "Call Date," in turn, is defined as the day the call exercise note is delivered.

[6] The agreement defines each of these numbers

EBITDA	equals the [LLC's] average annual EBITDA over the thirty-six calendar months preceding the Determination Date
N	equals the [LLC's] average annual Net Debt over the thirty-six calendar months preceding the Determination Date
I	equals the percentage of Interests (that is, as a percentage of all Membership Interests) being sold by the applicable Seller (and purchased by [Global])

During the parties' negotiations, the Lees proposed adding the following language to the Put/Call Agreement's "Formula Price" definition, which would have established a floor price for the Lees' membership interests: "Provided, however, that the Formula Price shall in no event be less than the Book Value of the respective Interests to be sold by each Seller." The record contains no indication that the proposed amendment ever was accepted by Global or otherwise became a part of the Put/Call Agreement.

The LLC's performance

As told by the Lees, the LLC performed well—its reported sales grew from just over $18 million in 2006 to more than $103 million in 2014, and the LLC reported more than $50 million in pretax net income during that time. But, as told by Global, the LLC's financial condition had substantially deteriorated by 2014 due to overexpansion.

In 2009, the LLC entered into a $37 million credit agreement with Global's parent company Sumitomo to facilitate an expansion program. Interest accrued and was paid on the Sumitomo-loaned money, and the credit facility was renewed and expanded in the ensuing years so that the LLC could buy inventory. By 2014, the LLC had borrowed more than $65 million. As the LLC's inventory levels increased, demand for the LLC's products diminished because of an energy market downturn.

From 2012 to 2014, the LLC wrote down more than $2.2 million in inventory, and, according to Global, the LLC's net income fell to $226,000 in 2014.

Global exercises its call option, and the Lees sue

In February 2015, Global terminated the Lees' employment without cause and gave the Lees notice of its intention to call their interests under the Put/Call Agreement. The call exercise notices calculated the Formula Price using the LLC's internally prepared financial statements. These financial statements were included in Global's consolidated financial statements and were audited by Global's regular auditor KPMG, yielding a negative value for the Lees' interests largely because of the LLC's substantial debt. This, according to Global, meant Global owed no contractual obligation to pay the Lees any amount to purchase their membership interests. Global also took the position that the Lees were not owed any unpaid Net Cash Flow distributions even though Global, as the LLC's manager, had never paid any such distributions. The only past distributions were for tax liabilities.

The Lees sued Global and the LLC, alleging that Global had improperly refused to pay Net Cash Flow distributions and erroneously calculated the Formula Price by, among other things, including loans from Sumitomo in Net Debt when those loans should have been excluded as "trade payables" in the ordinary course of business or because they reflected merely a cash management system between affiliate companies. The Lees further alleged that "the data for determining the

Formula Price under the Put/Call Agreement is required by the Agreement to be based on the audited financial statements of [the LLC]," not the consolidated audited financial statements. The Lees asserted that an independent, stand-alone audit of the LLC was required.

According to the Lees, Global's refusals and errors had deprived them of substantial unpaid distributions of at least $6.2 million under the LLC Agreement and almost $10 million under the Put/Call Agreement for their LLC membership interests. Based on these allegations, the Lees asserted contractual claims for breaches of the LLC Agreement and Put/Call Agreement and failure to correctly pay bonuses under their respective employment agreements; breach of Delaware's implied covenant of good faith and fair dealing;[7] breach of fiduciary duty; and an additional claim for declaratory judgment. The parties disagree whether the Lees also alleged a cause of action for violation of Delaware Limited Liability Act Section

[7] The parties do not dispute that Delaware law applies to the claims for breach of the LLC Agreement or that Delaware law generally includes an implied covenant of good faith and fair dealing; their dispute concerns *whether* and *how* the implied covenant should apply here.

18-604,[8] entitled "Distribution upon resignation," and Section 18-606,[9] entitled "Right to distribution."

Global and the LLC denied the allegations and asserted counterclaims for breach of contract and declaratory judgment. In response to the Lees' complaint about the lack of a stand-alone audit, however, Global retained the independent accounting firm of Briggs & Veselka ("B&V") to audit the LLC's financial statements. The B&V audit was completed during litigation, almost two years after Global exercised its call option, and, like the consolidated KPMG audit, yielded a negative price for the Lees' interests.

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[8] Delaware Code, Section 18-604, provides:

> Except as provided in this subchapter, upon resignation any resigning member is entitled to receive any distribution to which such member is entitled under a limited liability company agreement and, if not otherwise provided in a limited liability company agreement, such member is entitled to receive, within a reasonable time after resignation, the fair value of such member's limited liability company interests as of the date of resignation based upon such member's right to share in distributions from the limited liability company.

[9] Delaware Code, Section 18-606, provides:

> Subject to §§ 18-607 and 18-804 of this title, and unless otherwise provided in a limited liability company agreement, at the time a member becomes entitled to receive a distribution, the member has the status of, and is entitled to all remedies available to, a creditor of a limited liability company with respect to the distribution. A limited liability company agreement may provide for the establishment of a record date with respect to allocations and distributions by a limited liability company.

The trial court dismisses all the Lees' claims on summary judgment

Global and the LLC moved for a traditional and no-evidence summary judgment on all the Lees' claims, arguing that they were entitled to summary judgment as a matter of law because (1) the agreed-to Formula Price, as determined using the B&V audit, yielded a negative number, so no money was owed to the Lees for the exercise of Global's call option; (2) under the LLC Agreement, it was exclusively within Global's discretion, as the LLC's manager, not to make distributions of Net Cash Flow; and (3) the claim for breach of the implied covenant of good faith and fair dealing arising from unpaid distributions necessarily failed under Delaware law because distributions were not mandatory under the LLC Agreement. The Lees objected to Global's reliance on the B&V audit, arguing that it was untrustworthy because it was prepared for a litigation purpose and that it contained undesignated expert opinions from B&V regarding the audit's compliance with GAAP. Global and the LLC had not designated anyone from B&V as an accounting expert but had identified B&V as a fact witness.

The trial court granted a summary judgment dismissing the Lees' claims for breach of (1) the Put/Call Agreement, (2) the LLC Agreement, (3) the employment agreements, (4) fiduciary duty, and (5) Delaware's implied covenant of good faith and fair dealing. Thereafter, Global and the LLC dismissed their counterclaims without prejudice so as to make the trial court's summary judgment a final judgment.

The Lees moved for reconsideration of the trial court's summary-judgment ruling, but that motion was denied. The Lees appeal the dismissal of their claims for breach of the Put/Call Agreement, the LLC Agreement, Delaware's implied covenant of good faith and fair dealing, and for violations of the Delaware statutes. They do not appeal the dismissal of their other employment, fiduciary duty, and declaratory judgment claims.

Standard of Review

We review the trial court's summary judgment de novo. *See City of Richardson v. Oncor Elec. Delivery Co.*, 539 S.W.3d 252, 258 (Tex. 2018). When, as here, the trial court grants summary judgment without specifying the grounds for granting the motion, we affirm if any one of the grounds is meritorious. *Cmty. Health Sys. Prof'l Servs. Corp. v. Hansen*, 525 S.W.3d 671, 680 (Tex. 2017).

Although Global and the LLC's summary-judgment motion was a hybrid traditional and no-evidence motion, the claims for which the Lees seek review on appeal were addressed on traditional grounds. *See* TEX. R. CIV. P. 166a(c), (i). To prevail on a traditional summary-judgment motion, the movant must meet its burden to show that no genuine issue of material fact exists and that the trial court should grant judgment as a matter of law. TEX. R. CIV. P. 166a(c); *Oncor Elec.*, 539 S.W.3d at 258–59. To meet this burden, the movant must conclusively negate at least one essential element of each of the nonmovant's causes of action or conclusively prove

all the elements of an affirmative defense. *KCM Fin. v. Bradshaw*, 457 S.W.3d 70, 79 (Tex. 2015). A matter is conclusively proved if reasonable people could not differ as to the conclusion to be drawn from the evidence. *See City of Keller v. Wilson*, 168 S.W.3d 802, 816 (Tex. 2005).

If the movant does this, the burden shifts to the nonmovant to raise a genuine issue of material fact precluding summary judgment. *See Centeq Realty, Inc. v. Siegler*, 899 S.W.2d 195, 197 (Tex. 1995). Summary-judgment evidence raises a fact issue if reasonable and fair-minded jurors could differ in their conclusions on the evidence presented. *Goodyear Tire & Rubber Co. v. Mayes*, 236 S.W.3d 754, 755 (Tex. 2007) (per curiam). In our review, we take as true all evidence favorable to the nonmovant and indulge every reasonable inference and resolve any doubts in the nonmovant's favor. *Sommers for Ala. & Dunlavy, Ltd. v. Sandcastle Homes*, 521 S.W.3d 749, 754 (Tex. 2017).

Rules of Contract Construction

The Lees' four issues on appeal require us to construe the parties' agreements and consider the parties' competing constructions of their agreements.

While the Put/Call Agreement provides that it is governed by Texas law, the LLC Agreement is governed by Delaware law. We construe contracts as they are written. *See URI, Inc. v. Kleberg Cty.*, 543 S.W.3d 755, 763–64 (Tex. 2018) (explaining that primary concern of contract construction is to give effect to parties'

intentions as expressed in document, and instructing that "[o]bjective manifestations of intent control, not 'what one side or the other alleges they intended to say but did not.'") (quoting *Gilbert Tex. Constr., L.P. v. Underwriters at Lloyd's London*, 327 S.W.3d 118, 127 (Tex. 2010)); *In re Davenport*, 522 S.W.3d 452, 457 (Tex. 2017) ("We cannot make new contracts between the parties and must enforce the contract as writte."). We must consider the entire writing and strive to harmonize and give effect to all its provisions so that none will be rendered meaningless. *See Seagull Energy E&P, Inc. v. Eland Energy, Inc.*, 207 S.W.3d 342, 345 (Tex. 2006); *see also Coker v. Coker*, 650 S.W.2d 391, 394 (Tex. 1983) (explaining that court must favor interpretation that gives some consequence to each part of agreement so that no provision is rendered meaningless or given controlling effect). Contract terms will be given their plain, ordinary, and generally accepted meaning unless the contract itself shows them to be used in a technical or different sense. *See Valence Operating Co. v. Dorsett*, 164 S.W.3d 656, 662 (Tex. 2005).

"Delaware law adheres to the objective theory of contracts, *i.e.*, a contract's construction should be that which would be understood by an objective, reasonable third party." *Osborn ex rel. Osborn v. Kemp*, 991 A.2d 1153, 1159 (Del. 2010). The same general rules of construction apply under this theory. *See AT&T Corp. v. Lillis*, 953 A.2d 241, 252 (Del. 2008) (providing that court's construction of contract is constrained by combination of parties' words and plain meaning of those words

when no special meaning is intended); *Lorillard Tobacco Co. v. Am. Legacy Found.*, 903 A.2d 728, 739 (Del. 2006) (instructing that "clear and unambiguous language . . . should be given its ordinary and usual meaning"); *Council of the Dorset Condo. Apartments v. Gordon*, 801 A.2d 1, 7 (Del. 2002) (stating that courts should construe contracts so as to give effect to and harmonize all of provisions).

Formula Price

The Lees' second and fourth issues on appeal concern the trial court's summary judgment dismissing their claim for breach of the Put/Call Agreement, which is governed by Texas law. The Lees contend, in their second issue, that the summary judgment erroneously rests on inadmissible financial statements in B&V's stand-alone audit of the LLC. In their fourth issue, the Lees contend that they raised a fact issue as to whether the Formula Price for their membership interests was incorrectly calculated. We address these issues in turn.

A. Evidentiary challenges

There are two sets of audited financial statements: (1) those included in KPMG's consolidated audit of Global and the LLC and (2) those included in the audit performed by B&V, which we refer to as the "B&V statements." According to the Lees, the trial court should have rejected the B&V statements *in toto* because they were created outside the regular course of business for a litigation purpose, making them untrustworthy and inadmissible under the hearsay exception for

business records. *See* TEX. R. EVID. 802, 803(6). The Lees also complain that, at a minimum, B&V's statements in its reports regarding GAAP-compliance must be excluded because such statements are undisclosed expert opinions.

The rules of evidence control the admissibility of evidence in summary-judgment proceedings; thus, we review a trial court's decision to admit or exclude evidence for an abuse of discretion. *Seim v. Allstate Tex. Lloyds*, 551 S.W.3d 161, 163 (Tex. 2018). An abuse of discretion occurs when the trial court acts arbitrarily or without reference to any guiding rules and principles. *Simien v. Unifund CCR Partners*, 321 S.W.3d 235, 239 (Tex. App.—Houston [1st Dist.] 2010, no pet.). We must uphold the trial court's evidentiary ruling if there is any legitimate basis for the ruling. *Owens-Corning Fiberglas Corp. v. Malone*, 972 S.W.2d 35, 43 (Tex. 1998); *Simien*, 321 S.W.3d at 239. And we will set aside the trial court's judgment only if the "erroneous evidentiary ruling probably caused the rendition of an improper judgment." *Horizon/CMS Healthcare Corp. v. Auld*, 34 S.W.3d 887, 906 (Tex. 2000); *see* TEX. R. APP. P. 44.1(a)(1).

1. Business records

The exceptions to the hearsay rule are fundamentally policy decisions about the reliability of certain categories of hearsay evidence. *See In re WorldCom, Inc. Secs. Litig.*, No. 02 Civ.3288 DLC, 2005 WL 375313, at * 7 (S.D.N.Y. Feb. 17, 2005) (opinion and order). Rule of Evidence 803(6) deems business records

sufficiently reliable when the records are (1) made at or near the time of the events recorded, (2) from information transmitted by a person with knowledge of the events, and (3) made or kept in the course of a regularly conducted business activity. TEX. R. EVID. 803(6); *see Ortega v. Cach, LLC*, 396 S.W.3d 622, 631 (Tex. App.—Houston [14th Dist.] 2013, no pet.) (explaining that rationale for business-records exception is "two-fold: First, businesses depend on such records to conduct their own affairs, so employees . . . have a strong motive to be accurate . . . ; second, routine and habitual patterns of creation lend reliability to business records."). If these prerequisites are satisfied, the records are admissible unless the opponent shows that "the source of information or the method or circumstances of preparation indicate a lack of trustworthiness." TEX. R. EVID. 803(6).

As the proponents of the evidence, Global and the LLC submitted an employee affidavit from Global's Vice President of Finance authenticating the B&V statements as the LLC's business records. The affiant recites her familiarity with the manner in which the LLC's records are created and maintained and avers that the B&V statements are copies of "original documents kept by [the LLC] in the regular course of business, and it was the regular course of business of [the LLC] for an employee or representative of [the LLC], with knowledge of the act, event, condition, opinion, or diagnosis, recorded to make the record or to transmit

information thereof to be included in such record . . . ; and the record was made at or near the time or reasonably soon thereafter."

The Lees do not complain on appeal about the affidavit's form or the affiant's personal knowledge. Instead, they argue that the B&V statements are inadmissible under the business-records exception for two reasons: (1) the B&V audit does not satisfy the contemporaneity requirement and is not trustworthy because it did not occur "at or near" the time of the underlying events but rather occurred during litigation and (2) the B&V audit did not satisfy the regularity requirement because the LLC had not been audited previously as a stand-alone company and, thus, the B&V audit was not a regularly conducted business activity.

Rule 803(6)'s "at or near" requirement was satisfied here. The audit report was written contemporaneously with the activity it reflects: the examination of the entity's records. A contrary rule—a rule that defines contemporaneity by comparing the date of the report with the date of the underlying operations reflected in the records—would make routine audits and many other routine financial reports reviewing prior conduct per se inadmissible because there will always be some temporal gap associated with the generation of such reports given that, by nature, they generally are a look back in time. *See Pfeffer v. S. Tex. Laborers' Pension Tr. Fund*, 679 S.W.2d 691, 694 (Tex. App.—Houston [1st Dist.] 1984, writ ref'd n.r.e.) (explaining that payroll audit report was admissible as business record if report was

"made at or near the time of the examination, and not when the underlying work shown in the audited records was performed"); *In re WorldCom, Inc. Secs. Litig.*, 2005 WL 375313, at *8 (concluding it was consistent with policies underlying business-records exception to accept restatement of company's financials, in part, because "[a] financial statement is never created contemporaneously with the underlying business records; typically it is filed months after the end of the fiscal year whose results it purports to reflect").

The B&V statements were also made in the regular course of business. Audits by independent accounting firms performed in compliance with GAAP are a routine part of business. While an audit for a particular division or subsidiary company may be unusual for that company, the methods are the same as a consolidated audit.

Relatedly, the B&V statements were not shown to be untrustworthy. Relying on federal cases, the Lees argue that records of audits undertaken for a special purpose, as contrasted with regularly-established compliance audits, are inadmissible because they are untrustworthy. *See Paddack v. Dave Christensen, Inc.*, 745 F.2d 1258, 1258 (9th Cir. 1984) (affirming exclusion of audit as untrustworthy because trustees had no regular compliance audit and had ordered special audit in response to suspicion of irregularities); *Cincinnatus Partners I, LP v. Farm Bureau Prop. & Cas. Ins. Co.*, No. 1:11-cv-427, 2014 WL 12748898, at *3 (S.D. Ohio May 27, 2014) (finding that audit report was inadmissible hearsay because it was prepared

as "special project," not as part of "original audit plan," and therefore lacked trustworthiness); *In re Taylor*, 62 B.R. 846, 847, 852 (Bankr. E.D. Va. 1986) (observing that audit reports may be business records if evidence shows that audits "were conducted with any regularity" or that company had "regular compliance audit procedure"). But in none of those cases did the objecting party demand an independent audit or allege that the opposing party was contractually obligated to obtain one, as the Lees did here. And even if there were no pre-litigation, stand-alone audits of the LLC, it is undisputed that the LLC's financial statements were routinely audited on a consolidated basis with Global.

In our view, these circumstances together distinguish the B&V statements from the objected-to evidence in the cases cited by the Lees and do not indicate a lack of trustworthiness. We conclude that it was within the trial court's discretion to consider the B&V statements under the business-records exception. *See* TEX. R. EVID. 803(6); *Simien*, 321 S.W.3d at 239.

2. Expert opinions

Even though we have concluded that the trial court was within its discretion to admit the B&V statements as business records, there still may be some portion of the statements that is inadmissible. The Lees contend that B&V's opinions that the 2012, 2013, and 2014 financial statements were GAAP compliant were inadmissible because Global and the LLC did not designate B&V as an expert. The Lees rest their

contention on a line of cases applying Rule of Civil Procedure 193.6's evidentiary-exclusion rule in summary-judgment proceedings. *See* TEX. R. CIV. P. 193.6 (prohibiting party from offering evidence not timely disclosed in discovery unless (1) good cause excuses failure to make, amend, or supplement discovery response; or (2) failure to timely make, amend, or supplement discovery response will not unfairly surprise or unfairly prejudice opponent); *Fort Brown Villas III Condo. Ass'n, Inc. v. Gillenwater*, 285 S.W.3d 879, 882 (Tex. 2009) (holding that Rule 193.6 applies in summary-judgment proceedings and that party who fails to timely designate expert must establish good cause or lack of unfair surprise or prejudice before trial court may admit evidence); *Chau v. Riddle*, 212 S.W.3d 699, 704–05 (Tex. App.—Houston [1st Dist.] 2006), *rev'd on other grounds*, 254 S.W.3d 453, 455 (Tex. 2008) (same); *Cunningham v. Columbia/St. David's Healthcare Sys., L.P.*, 185 S.W.3d 7, 13 (Tex. App.—Austin 2005, no pet.) (same). Under these authorities, "[a] party who fails to timely designate an expert has the burden of establishing good cause or a lack of unfair surprise or prejudice before the trial court may admit the evidence." *Fort Brown Villas*, 285 S.W.3d at 881 (citing TEX. R. CIV. P. 193.6).

We need not reach the issue of whether Global and the LLC were required to designate B&V as an expert witness because the trial court reasonably could have concluded that Rule 193.6's exception for no unfair surprise or prejudice applied. *See* TEX. R. CIV. P. 193.6(a); *Cunningham*, 185 S.W.3d at 13 (stating that "a non-

designated expert's affidavit cannot be considered as summary judgment evidence *absent* a showing of good cause or a lack of unfair surprise or prejudice") (emphasis added). Global and the LLC retained B&V to perform the stand-alone audit in response to the Lees' suit and request for audited financial statements, and there is no dispute the Lees were aware of B&V's audit. Although the record does not establish precisely when Global and the LLC first produced the B&V statements, the parties agreed in post-submission briefing that the B&V statements were delivered by courier to the Lees on or around December 2, 2016. The Lees' expert's report indicates that he received the B&V statements about three days later. The expert's report further indicates that he gained access to B&V's audit workpapers and correspondence file in early February 2017. Global and LLC then moved for summary judgment in April 18, 2017, and the Lees filed their response on May 5. Accordingly, the Lees had the B&V statements for five months before their summary-judgment response was due, and there was no "trial by ambush." *See Alvarado v. Farah Mfg. Co.*, 830 S.W.2d 911, 914 (Tex. 1992) (op. on reh'g) (explaining that primary purpose of predecessor discovery rule was to prevent trial by ambush). The Lees were able to test B&V's statements by conducting discovery related to the B&V audit, and their expert had sufficient time to prepare a rebuttal of

the B&V audit and write a supplemental report challenging the B&V statements, which the Lees submitted with their summary-judgment evidence.[10]

We therefore conclude that the trial court was within its discretion to consider B&V's opinions about GAAP compliance as part of the summary-judgment proceedings. *Cf. In re Kings Ridge Homeowners Ass'n, Inc.*, 303 S.W.3d 773, 783–84 (Tex. App.—Fort Worth 2009, orig. proceeding) (considering, in determining whether unfair surprise or prejudice resulted from late designation, party had ample time to depose expert and retain rebuttal expert); *State v. Target Corp.*, 194 S.W.3d 46, 51 (Tex. App.—Waco 2006, no pet.) (holding that trial court abused its discretion by excluding late designated expert when adverse party had his report timely, deposed him twice, and had adequate opportunity to explore basis for opinions).

We overrule the Lees' second issue.[11]

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[10] Global and the LLC also point to the Lees' deposition of Sheila Enriquez, who supervised the B&V audit, about 10 days before the trial court issued its summary-judgment order. The Lees dispute that Enriquez's deposition can show a lack of prejudice or unfair surprise on the ground that Enriquez was not identified as a fact witness until after they filed their summary-judgment response. Because the discovery that allegedly identified Enriquez is not included in the appellate record, we cannot confirm the accuracy of the Lees' position. We note, however, that the Lees did not supplement their summary-judgment response, or move the trial court to delay its ruling, based on Enriquez's deposition, though they did rely on her testimony in moving for reconsideration after the trial court ruled.

[11] Given our conclusion that the trial court's evidentiary rulings are not an abuse of discretion, we need not address Global and the LLC's argument that any evidentiary error is unpreserved because the Lees failed to preserve their evidentiary argument by not obtaining a ruling on their objections before the trial court granted summary judgment.

B. Calculation of Formula Price

The Lees contend that their summary-judgment response, which incorporated their own affidavits, their accounting expert's affidavit and report, and numerous depositions and other documents, raised a fact issue as to whether Global and the LLC incorrectly calculated the Formula Price due to improper inventory charges, miscalculation of "Selling, General & Administrative" expenses, erroneous inclusion of the Sumitomo Loans as part of Net Debt, and improper calculation of cash equivalents. We need not decide whether such discrete fact issues exist because we conclude that Global and the LLC's contractual obligation was to draw the Formula Price calculation from the LLC's audited financial statements prepared in accordance with GAAP, and the record conclusively establishes that they did this.

Under the Put/Call Agreement, the Lees agreed to sell their membership interests to Global for an agreed-to price using a formula of ((EBITDA × 4) – Net Debt) × the Lees' Interest Percentage). The Lees refused to accept Global's initial calculation of Formula Price because it was not based on audited financial statements of the LLC as a stand-alone entity. Section 3.3(b) of the Put/Call Agreement provides that, "[i]f a Call Exercise Notice is delivered pursuant to the foregoing clause (a) of this section 3.3, then [the LLC] shall cause to be audited its financial statements (i) in the case the Formula Price shall be used to determine the purchase price of the Interests[.]" The contractual definitions of both EBITDA and Net Debt

make specific reference to audited financial statements, with the Net Debt definition specifically referencing audited financial statements prepared pursuant to Section 3.3(b). Thus, the Put/Call Agreement memorializes the parties' unambiguous agreement that the key metrics in the Formula Price (EBITDA and Net Debt) would be based on the LLC's audited financial statements prepared in accordance with GAAP.

The record conclusively establishes that Global and the LLC adhered to the Put/Call Agreement's plain text by arranging for an audit to be performed by an independent third-party auditing firm, B&V, and by applying the numbers drawn from the GAAP-audited financial statements directly into the Formula Price calculation. In other words, Global and the LLC followed the contract procedure for exercising the call option. The Lees made no argument in their summary-judgment response that Global and the LLC breached the Put/Call Agreement protocol by failing to act timely. On this record, we find no error in the trial court's summary judgment on the Lees' claim for breach of the Put/Call Agreement.

The Lees argue that the audited financial statements cannot be dispositive of their breach-of-contract claim under the Put/Call Agreement because Section 3.3(e) expressly permits them to "object to [Global's] Call Exercise Notice . . . (whether such objection relates to [Global's] right to deliver the Call Exercise Notice, *the purchase price specified in such Call Exercise Notice* or another reason)[.]"

(Emphasis added.) Upon a purchase-price objection, Section 3.3(e) obligated Global and the Lees to "negotiate in good faith to resolve such dispute." And if the dispute was not resolved within ten days after Global delivered the Call Exercise Notice, the Lees and Global had the "right to resort to legal proceedings to resolve the dispute." There is no allegation or evidence that Global did not negotiate in good faith. Thus, we fail to see how Section 3.3(e) precludes summary judgment on the Lees' claim for breach of the Put/Call Agreement. The Lees' competing valuation of the Formula Price may have created a fact issue in a case presenting a different procedural posture—i.e., one where the courts have been asked to render a declaratory judgment as to the correct Formula Price. But that is not the posture in which this case is presented on appeal.

We overrule the Lees' fourth issue challenging the summary judgment on their claim for breach of the Put/Call Agreement.

Net Cash Flow Distributions

In their first and third issues, the Lees challenge the summary judgment on their claims for breach of the LLC Agreement and Delaware's implied covenant of good faith and fair dealing and for violation of Delaware's Limited Liability Company Act, arguing that fact issues exist as to whether Global improperly refused to make Net Cash Flow distributions of at least $6 million for fiscal years 2006 through 2015 when it exercised its call option. Global takes the position that the LLC

Agreement conferred Global, as manager, with exclusive discretion whether to pay any Net Cash Flow distributions at all and, thus, Global's decision to not pay distributions is not a breach of any express or implied contractual obligation or statutory violation. We address these arguments in turn.

A. The LLC Agreement

Regarding the Lees' claim for unpaid distributions under the LLC Agreement, the parties offer competing interpretations of the distribution provisions in Section 9. Section 9 provides in relevant part:

> Net Cash Flow of the Company shall be computed and distributed among the Members pro rata in accordance with their respective Membership Interests. Distributions shall be paid at such time as determined by the Manager; provided that Distributions for Estimated Tax Liabilities (as defined below) shall be made quarterly pursuant to Section 9.1. Distribution for Estimated Tax Liabilities shall be subject to a true-up calculation as set forth in Section 9.3. No distributions or returns of capital will be made or paid if they would result in either the Company becoming insolvent or the net assets of the Company becoming less than zero.

This clause is followed by detailed provisions for not only the timing and calculation of tax-liability distributions but also for addressing excesses or shortages as those distributions relate to the Lees' actual tax obligations. There is no additional language regarding Net Cash Flow distributions.

The Lees emphasize the mandatory term "shall" in Section 9's first sentence to argue that, although Global had some discretion to decide *when* to distribute Net Cash Flow, Global could not decide to *never* distribute Net Cash Flow. *See Miller v.*

Spicer, 602 A.2d 65, 67 (Del. 1991) (indicating that word "shall" generally signals mandatory requirement). Global, relying on different language in Section 9's second sentence, asserts that its exclusive discretion to never pay Net Cash Flow derives from Section 9's disparate treatment of Net Cash Flow and tax-liability distributions. Global observes that while Section 9 expressly provides that tax-liability distributions must be made quarterly, it does not mandate a schedule for Net Cash Flow distributions; those distributions "shall be paid at such time as determined by the Manager[.]"

We cannot read either Section 9's first or second sentence in isolation to determine whether Net Cash Flow distributions are mandatory, as the Lees contend, or discretionary, as Global and the LLC contend. *See GMG Capital Inv., LLC v. Athenian Venture Partners I, L.P.*, 36 A.3d 776, 779 (Del. 2012); *In re Cencom*, 2000 WL 640676, at *5. Construing Section 9 as a whole and interpreting its plain text, we conclude that it cannot reasonably be read as contractually obligating Global to pay Net Cash Flow distributions to the Lees at the time of the call.

Section 9's first sentence prescribes the *manner* of any distributions, instructing that Net Cash Flow distributions (if they are made) must be done "pro rata" in accordance with the members' interests. The "shall" language limits the way in which distributions can be divided (pro rata) when they happen to be made. The sentence's plain terms do not obligate the payment of distributions. The first clause

of Section 9's next sentence then addresses when Net Cash Flow distributions will be paid—"at such time as determined by the Manager." Even the Lees acknowledge the discretionary nature of this language.

This language stands in contrast to the language concerning tax-liability distributions. Although Net Cash Flow distributions may be made at such time as determined by the Manager, Global must make tax-liability distributions quarterly. The LLC Agreement's drafters knew how to require distributions to be made at a specific time, but they refrained from doing so for Net Cash Flow distributions.

Section 9 limits Global's discretion in only three ways—(1) Global must make tax-liability distributions quarterly, (2) the tax-liability distributions must be reconciled with the Lees' actual tax obligations annually, and (3) Global may not make any distributions that would cause the LLC to become insolvent or hold less than zero net assets. Other than that part of Section 9 prohibiting Net Cash Flow distributions that would cause the LLC to become insolvent, the LLC Agreement does not impose any restraint against Global's exercise of its timing discretion for Net Cash Flow distributions.[12] Accordingly, Section 9 does not, as the Lees contend, provide any basis for an obligation to pay distributions beyond the mandatory tax-liability distributions.

[12] The Put/Call Agreement likewise does not require payment of any unpaid Net Cash Flow distributions at the time Global exercised its call option.

The discretionary nature of the Net Cash Flow distributions is made even more plain by consideration of Section 9's additional provisions for tax-liability distributions. Not only does the LLC Agreement instruct that tax-liability distributions shall be made quarterly, but it also sets forth, in Subsection 9.1, a "minimum quarterly distributions" calculation and, in Subsection 9.3, a method for "truing-up" any differences between estimated and actual tax obligations. These detailed, specific provisions for tax-liability distributions stand in contrast to those regarding Net Cash Flow distributions. The parties could have stated that Net Cash Flow distributions, like tax-liability distributions, would be made on a certain schedule or at times when Net Cash Flow exceeded a certain sum. But they did not. Under these circumstances, those omissions must be viewed as intentional in ascertaining the parties' intent from what they chose to include and what they chose to omit from their agreement.

As the LLC Agreement is written, Global could breach the contract, for example, by paying distributions in a manner other than pro rata or by failing to make quarterly tax-liability distributions. But we find no basis in the LLC Agreement for the Lees' breach-of-contract claim for unpaid Net Cash Flow distributions at the time Global exercised the call. Accordingly, we overrule that portion of the Lees' third issue challenging the summary judgment on their breach-of-contract claim for unpaid distributions under the LLC Agreement. We next

consider the Lees' unpaid-distributions claim in the context of Delaware's implied covenant of good faith and fair dealing.

B. Delaware's implied covenant of good faith and fair dealing

The Lees contend that even if Global's refusal to pay Net Cash Flow distributions when it called the Lees' interests was not a breach of the LLC Agreement, a fact issue nevertheless exists as to whether the refusal breached Delaware's implied covenant of good faith and fair dealing, which "requires a party in a contractual relationship to refrain from arbitrary or unreasonable conduct which has the effect of preventing the other party to the contract from receiving the fruits of the contract." *Wilgus v. Salt Pond Inv. Co.*, 498 A.2d 151, 159 (Del. Ch. 1985).

We conclude that Delaware's implied covenant of good faith and fair dealing does not apply here. The implied covenant is "best understood as a way of implying terms in [an] agreement, whether employed to analyze unanticipated developments or to fill gaps in the contract's provisions." *Dunlap v. State Farm Fire & Cas. Co.*, 878 A.2d 434, 441 (Del. 2005) (internal quotation omitted). Consequently, the first step in our analysis must be to consider whether a gap exists that must be filled. *In re El Paso Pipeline Partners, L.P. Derivative Litig.*, No. 7141-VCL, 2014 WL 2768782, at *17 (Del. Ch. June 12, 2014) (mem. op.). This means the contract itself remains paramount and the existing contract terms control. *Id.* As one court explained, "For Shakespeare, it may have been the play, but for a Delaware limited

liability company, *the contract's the thing*." *R&R Capital, LLC v. Buck & Doe Run Valley Farms, LLC*, No. 3803-CC, 2008 WL 3846318, at *1 (Del. Ch. Aug. 19, 2008) (mem. op.). The implied covenant "cannot be used to circumvent the parties' bargain, or to create a free-floating duty . . . unattached to the underlying legal document." *Dunlap*, 878 A.2d at 441 (internal quotation omitted). To that end, a party generally cannot assert a claim for breach of the implied covenant based on conduct authorized by the terms of the agreement. *See id.*; *In re El Paso Pipeline Partners*, 2014 WL 2768782, at *17 ("The implied covenant will not infer language that contradicts a clear exercise of an express contractual right.").

We have already concluded that the LLC Agreement—which defines the scope, structure, and nature of the LLC—expressly confers Global with full discretion as to *when* (and, relatedly, if) to distribute Net Cash Flow. That is, the contract is not silent on the issue of distribution timing, meaning there is no gap to fill using the implied covenant. The contract itself reveals that the parties considered and specifically addressed how and under what circumstances Net Cash Flow distributions would be made, not just when the LLC Agreement initially was executed in 2006 but also when its distribution provision was amended in 2014. And this is dispositive of the Lees' implied covenant claim. Delaware law does not permit this Court to employ the implied covenant in a manner that would effectively rewrite the contract to afford the Lees a better deal. "Parties have a right to enter into good

and bad contracts, the law enforces both." *Nemec v. Shrader*, 991 A.2d 1120, 1126 (Del. 2010).

In post-submission briefing, the Lees cited additional authority observing that the covenant may be something broader that, even in the absence of contractual gaps, operates in equity to restrain the exercise of Global's timing discretion for Net Cash Flow distributions and to prohibit actions or omissions that are unreasonable or, essentially, unfair. *See Winshall v. Viacom Int'l, Inc.*, 55 A.3d 629, 638 (Del. Ch. 2011) ("[W]hen a contract confers discretion on one party, the implied covenant of good faith and fair dealing requires that the discretion . . . be used reasonably and in good faith."); Mohsen Manesh, *Express Contract Terms and the Implied Contractual Covenant of Delaware Law*, 38 DEL. J. CORP. L. 1, 10 (2013) ("Delaware courts have over time adopted contradictory conceptions of the Implied Covenant. On one hand, Delaware courts describe the Covenant as a mere 'gap filler,' a doctrine that cannot be used to equitably rewrite the express terms of a bargained-for agreement. But at the same time, Delaware courts describe the Covenant in language that suggests the doctrine is something broader: an unwaivable, overriding obligation implied into every contract and judicially invoked when fairness dictates."). We construe this to be a different argument than the Lees made in their summary-judgment response, which focused on the LLC Agreement's construction and the implied covenant's gap-filling function rather than on the

application of equity to override the LLC Agreement's express terms; thus, it does not present a ground for reversal. *See McConnell v. Southside Indep. Sch. Dist.*, 858 S.W.2d 337, 341 (Tex. 1993) (explaining that any issue non-movant contends avoids movant's entitlement to summary judgment must be stated in written response). In any event, the same authorities cited by the Lees observe that a party "does not act in bad faith by relying on contract provisions for which that party bargained," and the summary-judgment record here establishes Global's exercise of contractual options for which it bargained and to which the Lees agreed. *Nemec*, 991 A.2d at 1128. "The policy underpinning the implied duty of good faith and fair dealing does not extend to post contractual rebalancing of the economic benefits flowing to the contracting parties." *Id.*

Accordingly, we overrule that part of the Lees' third issue challenging the summary judgment on the implied covenant claim.

C. Delaware Limited Liability Company Act

The Lees also contend that the trial court erroneously dismissed their claims under the Delaware Limited Liability Company Act for unpaid distributions because those claims were not the subject of any summary-judgment motion. It is well settled that summary judgments may only be granted upon grounds expressly asserted in the summary-judgment motion. TEX. R. CIV. P. 166a(c); *G&H Towing Co. v. Magee*, 347 S.W.3d 293, 297 (Tex. 2011). "Granting a summary judgment on a claim not

addressed in the summary judgment motion therefore is, as a general rule, reversible error." *Magee*, 347 S.W.3d at 297. Only when the omitted cause of action is precluded as a matter of law by other grounds raised in the case will we find the error harmless. *Id.* at 297–98; *see Mercedez-Benz Credit Corp. v. Rhyne*, 925 S.W.2d 664, 667 (Tex. 1996) (holding that wrongful denial of jury trial is harmful error only when case contains question of material fact); *Wilson v. Davis*, 305 S.W.3d 57, 73 (Tex. App.—Houston [1st Dist.] 2009, no pet.) (recognizing exception but requiring "a very tight fit between what was proved or disproved in the motion and what elements the unaddressed claim, as it was alleged, required; otherwise, the exception could swallow the rule"). An erroneous dismissal will not be overturned when the movant has conclusively proved or disproved a matter that would also preclude the unaddressed claim as a matter of law or the unaddressed claim is derivative of the addressed claim on which the movant has proved its entitlement to summary judgment. *See Magee*, 347 S.W.3d at 297–98.

Global and the LLC do not dispute that their summary-judgment motion did not address statutory claims; instead, they argue that the record does not show error because the Lees did not properly plead violations of the Delaware Limited Liability Company Act and, even if they did, those claims must be rejected as a matter of law because the LLC Agreement did not require Global to pay Net Cash Flow

distributions. We agree with Global and the LLC's second assertion that the error is harmless.

"Texas follows a 'fair notice' standard for pleading, in which courts assess the sufficiency of pleadings by determining whether an opposing party can ascertain from the pleading the nature, basic issues, and the type of evidence that might be relevant to the controversy." *Low v. Henry*, 221 S.W.3d 609, 612 (Tex. 2007); *see* TEX. R. CIV. P. 45 ("All pleadings shall be construed so as to do substantial justice."); TEX. R. CIV. P. 47 (requiring pleadings to contain "a short statement of the cause of action sufficient to give fair notice of the claim involved"). Stated differently, the fair-notice standard measures whether the pleadings provide the opposing party with sufficient information to enable that party to prepare a defense or a response. *See Low*, 221 S.W.3d at 612; *Stallworth v. Ayers*, 510 S.W.3d 187, 190 (Tex. App.—Houston [1st Dist.] 2016, no pet.).

The background section of the Lees' pleading includes a subsection entitled "Failure to pay distributions under the LLC Agreement." There, the Lees specifically referenced Sections 18-604 and 18-606 of the Delaware Limited Liability Company Act in support of allegations that "any resigning member of an LLC is entitled to receive any distributions that such member was entitled to under the LLC agreement" and that, "at the time a member becomes entitled to receive a distribution, the member has the status of and is entitled to the remedies available

to, a creditor of the LLC with respect to the distribution." The Lees further alleged that "[b]y exercising the Call and acquiring the interests of [the Lees], [the Lees] have effectively resigned from the LLC and are entitled to all unpaid distributions as a matter of Delaware law."

Although the Lees' allegations under the Act are not repeated in their pleading's "Causes of Action" section, we conclude that the factual allegations in the background section and specific statutory references therein sufficiently informed Global and the LLC of "the nature, basic issues, and the type of evidence that might be relevant to the controversy" under our liberal, fair-notice pleading standard. *See Low*, 221 S.W.3d at 612; *Roark v. Allen*, 633 S.W.2d 804, 810 (Tex. 1982) ("A petition is sufficient if it gives fair and adequate notice of the *facts* upon which the pleader bases his claim.") (emphasis added); *The Huff Energy Fund, L.P. v. Longview Energy Co.*, 482 S.W.3d 184, 219 (Tex. App.—San Antonio 2015, no pet.) ("Courts applying Texas's fair-notice pleading standard must review the allegations as a whole (which necessarily includes all factual allegations) to determine whether a pleading gives fair notice."). Accordingly, these statutory claims were live claims that Global and the LLC should have addressed in their summary-judgment motion.

The trial court's error in dismissing unaddressed claims, however, is harmless. *See Magee*, 347 S.W.3d at 297–98. The statutes on which the Lees base their claim

both expressly contemplate that distributions are controlled by the LLC Agreement's terms. *See* DEL. CODE tit. 6, §§ 18-604 (stating, in pertinent part, that "upon resignation any resigning member is entitled to receive any distribution *to which such member is entitled under a limited liability company agreement* . . . .") (emphasis added); 18-606 (stating, in pertinent part, that "*unless otherwise provided in a limited liability company agreement*, at the time a member becomes entitled to receive a distribution, the member has the status of, and is entitled to all remedies available to, a creditor of a limited liability company with respect to the distribution.") (emphasis added). Accordingly, our holding that the LLC Agreement does not provide any basis for an obligation to pay distributions beyond the mandatory tax-liability distributions also disposes of this claim.

We overrule the Lees' first issue.

Conclusion

Concluding that the record does not contain any reversible error, we affirm the trial court's summary judgment.

Harvey Brown
Justice

Panel consists of Chief Justice Radack and Justices Brown and Caughey.