

CHOICE OF ENTITY DECISION TREE

By

**BYRON F. EGAN
Jackson Walker L.L.P.
2323 Ross Avenue, Suite 600
Dallas, Texas 75201
began@jw.com**



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Byron F. Egan
Biographical Information

Jackson Walker L.L.P.
2323 Ross Avenue, Suite 600
Dallas, Texas 75201

Phone: (214) 953-5727
Email: began@jw.com
www.jw.com

Practice: Byron F. Egan is a partner of *Jackson Walker L.L.P.* in Dallas. He is engaged in a corporate, partnership, securities, mergers and acquisitions (“M&A”) and financing practice. Mr. Egan has extensive experience in business entity formation and governance matters, M&A and financing transactions in a wide variety of industries including energy, financial and technology. In addition to handling transactions, he advises boards of directors and their audit, compensation and special committees with respect to fiduciary duty and other corporate governance issues, the Sarbanes-Oxley Act, special investigation and other issues.

Involvement: Mr. Egan is Senior Vice Chair and Chair of Executive Council of the M&A Committee of the American Bar Association and served as Co-Chair of its Asset Acquisition Agreement Task Force, which wrote the *Model Asset Purchase Agreement with Commentary*. He is immediate Past Chair of the Texas Business Law Foundation; is a former Chair of the Business Law Section of the State Bar of Texas and former Chair of that section’s Corporation Law Committee; and on behalf of these groups, has been instrumental in the drafting and enactment of many Texas business entity and other statutes. He is also a member of the American Law Institute.

Publications: Mr. Egan writes and speaks about the areas in which his law practice is focused, and is a frequent author and lecturer regarding M&A, governance of corporations, partnerships and limited liability companies, securities laws, and financing techniques. Mr. Egan has written or co-authored the following law journal articles: Corporate Governance: *Fiduciary Duties of Corporate Directors and Officers in Texas*, 43 Texas Journal of Business Law 45 (Spring 2009); *Responsibilities of Officers and Directors under Texas and Delaware Law*, XXVI Corporate Counsel Review 1 (May 2007); Entity Choice and Formation: *Joint Venture Formation*, 44 Texas Journal of Business Law 129 (2012); *Choice of Entity Decision Tree After Margin Tax and Texas Business Organizations Code*, 42 Texas Journal of Business Law 171 (Spring 2007); *Choice of Entity Alternatives*, 39 Texas Journal of Business Law 379 (Winter 2004); *Choice of State of Incorporation – Texas Versus Delaware: Is it Now Time to Rethink Traditional Notions*, 54 SMU Law Review 249 (Winter 2001); M&A: *Confidentiality Agreements are Contracts with Long Teeth*, 46 Texas Journal of Business Law 1 (Fall 2014); *Private Company Acquisitions: A Mock Negotiation*, 116 Penn St. L. Rev. 743 (2012); *Asset Acquisitions: Assuming and Avoiding Liabilities*, 116 Penn St. L. Rev. 913 (2012); *Asset Acquisitions: A Colloquy*, X U. Miami Business Law Review 145 (Winter/Spring 2002); Securities Law: *Major Themes of the Sarbanes-Oxley Act*, 42 Texas Journal of Business Law 339 (Winter 2008); *Communicating with Auditors After the Sarbanes-Oxley Act*, 41 Texas Journal of Business Law 131 (Fall 2005); *The Sarbanes-Oxley Act and Its Expanding Reach*, 40 Texas Journal of Business Law 305 (Winter 2005); *Congress Takes Action: The Sarbanes-Oxley Act*, XXII Corporate Counsel Review 1 (May 2003); and Legislation: *The Role of the Business Law Section and the Texas Business Law Foundation in the Development of Texas Business Law*, 41 Texas Journal of Business Law 41 (Spring 2005).

Education: Mr. Egan received his B.A. and J.D. degrees from the University of Texas. After law school, he served as a law clerk for Judge Irving L. Goldberg on the United States Court of Appeals for the Fifth Circuit.

Honors: For over ten years, Mr. Egan has been listed in The Best Lawyers in America under Corporate, M&A or Securities Law. He is the 2015 recipient of the Texas Bar Foundation’s Dan Rugeley Price Memorial Award, which is presented annually to a lawyer who has an unreserved commitment to clients and to the legal profession. He won the Burton Award for Legal Achievement four times. Mr. Egan has been recognized as one of the top corporate and M&A lawyers in Texas by a number of publications, including Corporate Counsel Magazine, Texas Lawyer, Texas Monthly, The M&A Journal (which profiled him in 2005) and Who’s Who Legal. In 2009, his paper entitled “Director Duties: Process and Proof” was awarded the Franklin Jones Outstanding CLE Article Award and an earlier version of that article was honored by the State Bar Corporate Counsel Section’s Award for the Most Requested Article in the Last Five Years.

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CHOICE OF ENTITY DECISION TREE

BY

BYRON F. EGAN*

CHAPTER 1. INTRODUCTION.

1.1. General. In selecting a form of business entity for operations in Texas the following five business entity forms are available:

- Corporation
- General Partnership
- Limited Partnership
- Limited Liability Partnership (“LLP”)
- Limited Liability Company (“LLC”)

The form of business entity most advantageous in a particular situation depends on the business objectives for which the entity is being organized. In most situations, the choice of entity focus will be on how the entity and its owners will be taxed and the extent to which the entity will shield the owners and managers of the business from liabilities arising out of its activities. An increasingly important factor in choosing the form of entity, and its state of domicile, is the extent to which the fiduciary duties and personal liability of the entity’s board of directors (“Board”) or other governing persons may be limited in the entity’s governing documents.

Until the 1990s, the spectrum of business entity forms available in Texas was not as broad as it is today. In 1991, the Texas Legislature passed the world’s first LLP statute permitting a general partnership to significantly limit the individual liability of its partners for certain acts of other partners by the partnership making a specified filing with the Secretary of State of Texas (the “Secretary of State”) and complying with certain other statutory requirements.¹ The Texas LLP statute was later amended to extend its LLP shield to contracts.

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Byron F. Egan is a partner of Jackson Walker L.L.P. in Dallas, Texas. Mr. Egan is Senior Vice Chair and Chair of the Executive Council of the ABA Business Law Section’s Mergers & Acquisitions Committee and former Chair of its Asset Acquisition Agreement Task Force, and a member of the American Law Institute. Mr. Egan is immediate past Chairman of the Texas Business Law Foundation and is also former Chairman of the Business Law Section of the State Bar of Texas and of that Section’s Corporation Law Committee.

The author wishes to particularly acknowledge the contribution of Steven D. Moore of Jackson Walker L.L.P. in Austin in preparing the Margin Tax discussions in this paper. The contributions of the following are also acknowledged: William H. Hornberger, Ronald D. Kerridge, Michael L. Laussade, David D. Player and Ashley Withers of Jackson Walker L.L.P. in Dallas.

¹ Act of May 9, 1961, 57th Leg., R.S., ch. 158, 1961 Tex. Gen. Laws 289; Act of May 17, 1979, 66th Leg., R.S., ch. 723, § 5, 1979 Tex. Gen. Laws 1782; Act of May 9, 1985, 69th Leg., R.S., ch. 159, § 76, 1985 Tex. Gen. Laws 692; Act of May 9, 1991, 72d Leg., R.S., ch. 901, §§ 83–85, 1991 Tex. Gen. Laws 3234-35; Act of May 31, 1993, 73d Leg., R.S., ch. 917, § 2, 1993 Tex. Gen. Laws 3912-13 (expired Jan. 1, 1999); *see* Susan

Also in 1991, Texas became the fourth state to adopt a statute providing for the creation of an LLC, which limits the personal liability of LLC interest owners for LLC obligations at least as much as the liability of corporate shareholders is limited for corporate obligations. Today, all fifty states and the District of Columbia have adopted LLP and LLC statutes,² and the LLC has become the entity of choice for private deals.³

The Texas Legislature enacted the Texas Business Organizations Code (the “TBOC”)⁴ to codify the Texas statutes relating to business entities referenced above, together with the Texas statutes governing the formation and operation of other for-profit and non-profit private sector entities. The TBOC is applicable to entities formed or converting under Texas law after January 1, 2006. Entities in existence on January 1, 2006 could continue to be governed by the Texas source statutes until January 1, 2010, after which time they must conform to the TBOC,⁵ although they could elect to be governed by the TBOC prior to that time.⁶

Like Texas, Delaware has a body of statutory and case law relating to corporations as well as other entities (collectively often referred to as “alternative entities”), including partnerships (general and limited) and LLCs. Those statutes include the Delaware General Corporation Law (as amended, the “DGCL”),⁷ the Delaware Revised Uniform Partnership Act (“DRPA”),⁸ the Delaware Revised Limited Partnership Act (“DRLPA”),⁹ and the Delaware Limited Liability Company Act (the “DLLCA”).¹⁰

Federal and state taxation of an entity and its owners for entity income is a major factor in the selection of the form of entity for a particular situation. Under the United States (“U.S.”) Internal Revenue Code of 1986, as amended (the “IRC”), and the “Check-the-Box” regulations promulgated by the Internal Revenue Service (“IRS”), an unincorporated business entity may be classified as an “association” taxable as a corporation subject to income taxes at the corporate level ranging from 15% to 35% of taxable net income, absent a valid S-corporation status election, which is in addition to any taxation which may be imposed on the owner as a result of distributions from the business entity.¹¹ Alternatively, the entity may be classified as a

S. Fortney, *Professional Responsibility and Liability Issues Related to Limited Liability Law Partnerships*, 39 S. TEX. L. REV. 399, 402 (1998).

² J. William Callison, *Changed Circumstances: Eliminating the Williamson Presumption that General Partnership Interests Are Not Securities*, 58 BUS. LAW. 1373, 1382 (2003).

³ Statistical information provided by the Secretary of State shows that on December 31, 2014 there were 653,326 active Texas LLCs compared with 370,070 active Texas for-profit corporations, 133,314 active Texas limited partnerships and 3,789 active Texas LLPs, and in 2014 new Texas entities formed were as follows: 121,592 LLCs, 36,445 for-profit corporations, 9,637 limited partnerships and 758 LLPs.

⁴ TEX. BUS. ORGS. CODE ANN. (Vernon 2015), available at www.statutes.legis.state.tx.us/docs/bo/htm/bo.1.htm.

⁵ TBOC § 402.005.

⁶ TBOC § 402.003.

⁷ DEL. CODE ANN. tit. 8, §§ 101 *et seq.* (Supp. 2015).

⁸ DEL. CODE ANN. tit. 6, §§ 15-101 *et seq.* (Supp. 2015).

⁹ DEL. CODE ANN. tit. 6, §§ 17-101 *et seq.* (Supp. 2015).

¹⁰ DEL. CODE ANN. tit. 6, §§ 18-101 *et seq.* (Supp. 2015).

¹¹ See Appendix A – Federal Taxation of Entities.

partnership, a non-taxable “flow-through” entity in which taxation is imposed only at the ownership level. Although a corporation is classified only as a corporation for IRC purposes, an LLC or partnership may elect whether to be classified as a partnership. A single-owner LLC is disregarded as a separate entity for federal income tax purposes unless it elects otherwise. In addition to federal tax laws, an entity and its advisors must comply with federal anti money laundering and terrorist regulations.¹² Further information regarding the IRC as it applies to entities is included in Appendix A – Federal Taxation of Entities.

Texas does not have a state personal income tax. The Texas Legislature has replaced the Texas franchise tax on corporations and LLCs with a novel business entity tax called the “Margin Tax,” which is imposed on all business entities other than general partnerships wholly owned by individuals and certain “passive entities.”¹³ Essentially, the calculation of the Margin Tax is based on a taxable entity’s, or unitary group’s, gross receipts after deductions for either (x) compensation or (y) cost of goods sold, provided that the “tax base” for the Margin Tax may not exceed 70% of the entity’s total revenues. This “tax base” is apportioned to Texas by multiplying the tax base by a fraction of which the numerator is Texas gross receipts and the denominator is aggregate gross receipts. The tax rate applied to the Texas portion of the tax base for reports due in 2015 is 0.95% for all taxpayers except a narrowly defined group of retail and wholesale businesses which pay a 0.475% rate.¹⁴ Effective January 1, 2016 those tax rates are 0.75% and 0.375%, respectively.¹⁵ For calendar year taxpayers, the Margin Tax is payable annually on May 15 of each year based on entity income for the year ending the preceding December 31. Further information regarding the Margin Tax is included in Appendix B – Texas Margin Tax.

The enactment of the Margin Tax changed the calculus for entity selections, but not necessarily the result. The LLC became more attractive as it can elect to be taxed as a corporation or partnership for federal income tax purposes, but the uncertainties as to an LLC’s treatment for self-employment purposes continue to restrict its desirability in some situations.¹⁶

1.2. Statutory Updating.

Texas’ entity statutes are continually being updated and improved through the efforts of the Texas Business Law Foundation and the Business Law Section of the State Bar of Texas in an effort to make Texas a more attractive jurisdiction for the organization of entities.¹⁷ This

¹² An entity and its advisors are charged with reviewing and complying with the Specially Designated Nationals List (“SDN List”) maintained by the Office of Foreign Assets Control (“OFAC”) within the United States (“U.S.”) Department of Treasury. U.S. citizens and companies (subject to certain exclusions typically conditioned upon the issuance of a special license) are precluded from engaging in business with any individual or entity listed on the SDN List. The SDN List and OFAC guidance are available on the OFAC website at <http://www.ustreas.gov/offices/enforcement/ofac/>.

¹³ See Appendix B – Texas Margin Tax.

¹⁴ See Section 2 of HB 500 83rd Tex. Leg. Session (effective for reports originally due on or after January 1, 2015 and before January 1, 2016).

¹⁵ Id. § 171.002 as amended in the 2015 Legislative Session by H.B. 32.

¹⁶ See Appendix A – Federal Taxation of Entities.

¹⁷ See generally Alan R. Bromberg, Byron F. Egan, Dan L. Nicewander, and Robert S. Trotti, *The Role of the Business Law Section and the Texas Business Law Foundation in the Development of Texas Business Law*,

updating process commenced in 1950 with the organization of the State Bar’s Corporation Law Committee, which was succeeded in 1953 by what is now the Business Law Section and was later enhanced by the organization of the Texas Business Law Foundation.¹⁸ This tradition continued in the 84th Texas Legislature, Regular Session (the “2015 Legislative Session”), which convened on January 13, 2015 and adjourned on June 1, 2015.¹⁹

1.3. Texas Business Organizations Code.

1.3.1. Background. After unsuccessful efforts in the 1999 and 2001 Sessions of the Texas Legislature, the TBOC was again introduced and finally passed in the 78th Session of the Texas Legislature (the “2003 Legislative Session”), which convened January 14, 2003 and adjourned *sine die* on June 2, 2003.²⁰ The TBOC prior to the 2015 Legislative Session included amendments made in 2005,²¹ 2007,²² 2009,²³ 2011²⁴ and 2013.²⁵ The TBOC is still a work in

41 TEX. J. BUS. L. 41 (2005) (displaying the continually changing statutes); see Alan R. Bromberg, *Texas Business Organization and Commercial Law—Two Centuries of Development*, 55 SMU L. REV. 83, 113–14 (2002); Alan R. Bromberg, Byron F. Egan, Dan L. Nicewander, and Robert S. Trotti, *The Role of the Business Law Section and the Texas Business Law Foundation in the Development of Texas Business Law*, 31 BULL. BUS. L. SEC. ST. B. TEX. 1 (1994).

¹⁸ *Id.*

¹⁹ Daryl B. Robertson, *Business Law*, Tex. Bar J., Vol. 78, No. 8, Sept. 2015.

²⁰ Tex. H.B. 1156, 78th Leg., R.S. (2003) by Rep. Helen Giddings, available at <http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=78R&Bill=HB1156> (“2003 H.B. 1156”). The “Revisor’s Report” for the TBOC is available at both www.texasbusinesslaw.org and on the Texas Legislative Council website at http://www.tlc.state.tx.us/legal/bocode/bo_revisors_report.html. The interim report from the House Sub-Committee studying the TBOC, which contains a side-by-side comparison of the TBOC and its source law, is available at <http://www.house.state.tx.us>.

²¹ In the 79th Session of the Texas Legislature (the “2005 Legislative Session”), which convened January 11, 2005 and adjourned *sine die* on May 30, 2005, changes were again made to the Texas entity statutes, including the TBOC. Tex. H.B. 1507, 79th Leg., R.S. (2005) by Rep. Burt Solomons, available at <http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=79R&Bill=HB1507> (“2005 H.B. 1507”); Tex. H.B. 1154, 79th Leg., R.S. (2005) by Rep. Gary Elkins, available at <http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=79R&Bill=HB1154>; Tex. H.B. 1319, 79th Leg., R.S. (2005) by Rep. Helen Giddings, available at <http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=79R&Bill=HB1319> (“2005 H.B. 1319”).

²² In the 80th Session of the Texas Legislature (the “2007 Legislative Session”), which convened January 9, 2007 and adjourned *sine die* on May 28, 2007, further changes were made to the TBOC and other Texas statutes affecting business entities. See Tex. H.B. 1737, 80th Leg., R.S. (2007) by Rep. Helen Giddings, available at <http://www.legis.state.tx.us/BillLookup/Text.aspx?LegSess=80R&Bill=HB1737> (“2007 H.B. 1737”), which became effective September 1, 2007; Daryl B. Robertson, *2007 Amendments to the Texas Business Organizations Code*, 42 TEX. J. BUS. L. 257 (Fall 2007).

²³ Additional changes were made to the TBOC and other Texas statutes affecting business entities in the 81st Session of the Texas Legislature (the “2009 Legislative Session”), which convened on January 13, 2009 and adjourned *sine die* June 1, 2009. See Rick Tulli & Daryl Robertson, *2009 Legislative Update on Texas Business Organizations Code Amendments*, 43 TEX. J. BUS. L. 571 (Winter 2009); Byron F. Egan, *Choice of Entity Alternatives* (May 28, 2010), available at <http://www.jw.com/site/jsp/publicationinfo.jsp?id=1396>, which at Appendix D describes (i) S.B. 1442 by Sen. Troy Fraser (generally updating the TBOC), available at <http://www.legis.state.tx.us/BillLookup/Text.aspx?LegSess=81R&Bill=SB1442> (“2009 S.B. 1442”), and (ii) H.B. 1787 by Rep. Burt Solomons (amending TBOC provisions pertaining to the designation of registered agents for service of process), available at <http://www.legis.state.tx.us/BillLookup/Text.aspx?LegSess=81R&Bill=HB1787> (“2009 H.B. 1787”).

progress, and will be amended in subsequent Legislative Sessions as gaps and ambiguities are discovered, and as business organization practices and needs evolve. The TBOC provides considerable flexibility to organizations in establishing their capital structures, effecting business combination transactions and governing their internal affairs. It is a model for future statutes nationwide and solidifies Texas' position as a leader in corporate law.

1.3.2. Source Law Codified. The TBOC is principally a codification of the existing Texas statutes governing non-profit and for-profit private-sector entities, rather than substantive

²⁴ The TBOC was amended in the 82nd Texas Legislature, 2011 Regular Session (the “2011 Legislative Session”), which convened on January 11, 2011 and adjourned on May 30, 2011, by the following bills, which were sponsored by the Texas Business Law Foundation, to be effective September 1, 2011:

S.B. 748 (“2011 S.B. 748”) by Sen. John J. Carona was a 58-page package of amendments to the corporation, non-profit corporation, partnership and LLC provisions of the TBOC to address issues that have arisen in recent experience under the TBOC and to make the statute more user friendly for Texas entities, *available at* <http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=82R&Bill=SB748>.

S.B. 323 (“2011 S.B. 323”) by Sen. John J. Carona amended the TBOC to provide that the TBOC provisions that limit the liability of shareholders of Texas corporations apply to managers and members of Texas LLCs if LLC “veil piercing” becomes recognized in Texas, *available at* <http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=82R&Bill=SB323>.

S.B. 1568 (“2011 S.B. 1568”) by Sen. Craig Estes clarified that a derivative plaintiff must own stock at the time of filing the derivative action and continuously to the completion of the action, *available at* <http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=82R&Bill=SB1568>.

See Byron F. Egan, *Business Entities in Texas after 2011 Texas Legislature*, TexasBarCLE Webcast on Legislative Changes Affecting Business Entities, July 13, 2011, *available at* <http://www.jw.com/publications/article/1629>; Daryl B. Robertson, *2011 Legislative Update: Amendments to the Texas Business Organizations Code and Texas Business and Commerce Code*, XXX CORP. COUNS. REV. 159 (Nov. 2011).

The Texas Business Law Foundation also sponsored the following legislation in the 2011 Legislative Session:

H.B. 2991 (“2011 H.B. 2991”) by Rep. Joe Deshotel amended chapter 271 of the Texas Business and Commerce Code effective September 1, 2011 to add additional safe harbors for choosing the law of a particular jurisdiction to govern large transactions, *available at* <http://www.legis.state.tx.us/BillLookup/history.aspx?LegSess=82R&Bill=HB2991>.

S.B. 782 (“2011 S.B. 782”) by Sen. John Carona amended Texas Business and Commerce Code Chapter 9 effective July 1, 2013 to adopt changes to Uniform Commercial Code Article 9 approved and recommended by the National Conference of Commissioners on Uniform State Laws for enactment in all states (the majority of the changes are in the nature of language adjustments for clarity or to update Article 9 to reflect advances in technology or business practices), *available at* <http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=82R&Bill=SB782>.

Further information regarding each of the five bills referenced above appears in Appendix E (*Legislation Sponsored by the Texas Business Law Foundation in the 2011 Legislative Session*) to Byron F. Egan, *Choice of Entity Decision Tree* (May 24, 2013), *available at* <http://www.jw.com/publications/article/1846>.

²⁵ The tradition of TBOC refinement continued in the 83rd Texas Legislature, 2013 Regular Session (the “2013 Legislative Session”), which convened on January 11, 2013 and adjourned on May 27, 2013. *See* Byron F. Egan, *Legislative Update: Business Law*, TexasBarCLE Webcast on Legislative Update: Business Law, July 2, 2013, *available at* <http://www.jw.com/publications/article/1871>

modifications to existing law.²⁶ These statutes, which are now repealed and replaced by the TBOC, consisted of the following: the Texas Business Corporation Act (the “TBCA”),²⁷ the Texas Non-Profit Corporation Act (the “TNPCA”),²⁸ the Texas Miscellaneous Corporation Laws Act (the “TMCLA”),²⁹ the Texas Limited Liability Company Act (the “LLC Act”),³⁰ the Texas Revised Partnership Act (the “TRPA”),³¹ the Texas Revised Limited Partnership Act (the “TRLPA”),³² the Texas Real Estate Investment Trust Act (the “TREITA”),³³ the Texas Uniform Unincorporated Nonprofit Associations Act (the “TUUNA”),³⁴ the Texas Professional Corporation Act (the “TPCA”),³⁵ the Texas Professional Associations Act (the “TPAA”),³⁶ the Texas Cooperative Associations Act (the “TCAA”),³⁷ and other existing provisions of Texas statutes governing private entities. Banks, trust companies, savings associations, insurance companies, railroad companies, cemetery organizations, and certain abstract or title companies organized under other special Texas statutes are not “domestic entities”³⁸ under the TBOC; therefore, they are governed by the TBOC only to the extent that the special Texas statute or its source laws incorporate the TBOC by reference or the TBOC is not inconsistent with the special statute.³⁹ Generally entities organized under Texas special statutes prior to January 1, 2006 were subject to the transition rules applicable to other Texas entities and continued to generally reference the source law rather than the TBOC until January 1, 2010, after which all Texas entities are governed by the TBOC.⁴⁰

1.3.3. Hub and Spoke Organization of Code. The TBOC adopts a “hub and spoke” organizational approach under which provisions common to all entities are included in a central “hub” of the TBOC found in Title 1. These common provisions include, for example, the primary sections governing purposes and powers of entities, filings, meetings and voting,

²⁶ Ad Hoc Codification Committee, *Report of the Codification Committee of the Section of Business Law of the State Bar of Texas on the Proposed Business Organizations Code*, Apr. 16, 2002, at 55, (hereinafter “Codification Comm. Report”) available at : <https://texasbusinesslaw.org/committees/business-organizations-code/revisors-report-on-the-business-organizations-code> (note: you may need to sign in to the website of the Business Law Section of the State Bar of Texas in order to properly view the report; you may sign in using your Texas Bar Number and the password you use for the State Bar of Texas website).

²⁷ TEX. BUS. CORP. ACT ANN. arts. 1.01 *et. seq.* (Vernon Supp. 2015) (hereinafter “TBCA”).

²⁸ TEX. REV. CIV. STAT. ANN. art. 1396-1 (Vernon Supp. 2015) (hereinafter “TNPCA”).

²⁹ TEX. REV. CIV. STAT. ANN. art. 1302 (Vernon Supp. 2015) (hereinafter “TMCLA”).

³⁰ TEX. REV. CIV. STAT. ANN. art. 1528n (Vernon Supp. 2015) (hereinafter “LLC Act”).

³¹ TEX. REV. CIV. STAT. ANN. art. 6132b (repealed 1999) (hereinafter “TRPA”).

³² TEX. REV. CIV. STAT. ANN. art. 6132a-1 (Vernon Supp. 2015) (hereinafter “TRLPA”).

³³ TEX. REV. CIV. STAT. ANN. art. 6138A (Vernon Supp. 2015) (hereinafter “TREITA”).

³⁴ TEX. REV. CIV. STAT. ANN. art. 1396-1B (Vernon Supp. 2015) (hereinafter “TUUNA”).

³⁵ TEX. REV. CIV. STAT. ANN. art. 1528e (Vernon Supp. 2015) (hereinafter “TPCA”).

³⁶ TEX. REV. CIV. STAT. ANN. art. 1528f (Vernon Supp. 2015) (hereinafter “TPAA”).

³⁷ TEX. REV. CIV. STAT. ANN. art. 1396-1A (Vernon Supp. 2015) (hereinafter “TCAA”).

³⁸ TBOC § 2.003.

³⁹ TBOC § 23.001.

⁴⁰ TBOC § 402.005. Note that the Texas Finance Code has been amended by 2007 H.B. 1962 to provide that bank associations and trust companies organized after January 1, 2006 are governed by the TBOC. Tex. H.B. 1962, §§ 12 and 68, 80th Leg., R.S. (2007), available at <http://www.capitol.state.tx.us/BillLookup/History.aspx?LegSess=80R&Bill=HB1962> (“2007 H.B. 1962”).

liability, indemnification of directors and partners, and mergers among entities. Outside of Title 1, separate “spokes” contain provisions governing different types of entities which are not common or similar among the different entities. To determine applicable law for a given business entity, one should look first to the general provisions in Title 1, and then to the entity-specific provisions containing additions and modifications to the general rules. However, where a direct conflict exists between a provision of Title 1 and a provision of any other Title, the other Title will govern the matter.⁴¹

1.3.4. Effective Date. The TBOC became effective on January 1, 2006 and applies to all domestic entities either organized in Texas or resulting from a conversion that takes effect on or after that date.⁴² Domestic entities already in existence on January 1, 2006 continued to be governed by then existing entity statutes until January 1, 2010,⁴³ at which time the source laws were repealed and all domestic entities became subject to the TBOC. However, such entities could elect to be governed by the TBOC prior to that date by making a filing with the Secretary of State of Texas and amending their governing documents as necessary.⁴⁴

1.3.5. Changes Made By the TBOC. The TBOC, which had been under development since 1995, was a joint project of the Business Law Section of the State Bar of Texas, the office of the Texas Secretary of State and the Texas Legislative Council,⁴⁵ and was passed with the endorsement and strong support of the Texas Business Law Foundation. In the codification process, the general objective was not to make substantive revisions to the existing Texas statutes. However, the TBOC did change the form and procedures of many of the existing provisions, and some substantive changes did occur. Some of the more general changes, as well as basic transition and construction provisions, are summarized below. Other changes that are more entity-specific are addressed in the appropriate sections of this article.

(a) **Vocabulary.** In an effort to streamline laws that govern business entities, the TBOC uses new terms to denote concepts and filings that previously were common to many different entity types but under different names. For example, each entity typically has a particular person or set of persons which govern that type of entity. For limited partnerships, that person is the general partner; for corporations, it is the board of directors; and for LLCs, it is either the managers or members, as specified in the LLC’s formation documents. The TBOC replaces all those different terms and simply refers to the persons or entities that control the entity as that entity’s “governing authority.”⁴⁶ Similarly, the name of the document a filing entity must file with the Secretary of State to be duly organized under Texas law is now simply called a “certificate of formation,” whereas previously each entity had its own name for such

⁴¹ TBOC § 1.106(c).

⁴² TBOC § 402.001(a).

⁴³ TBOC § 402.005.

⁴⁴ TBOC § 402.003.

⁴⁵ Revisor’s Report, *supra* note 20. The Bar Committee was primarily responsible for drafting the TBOC in collaboration with the Secretary of State and the Texas Legislative Council.

⁴⁶ TBOC § 1.002(35).

document.⁴⁷ One other significant vocabulary change is that the Regulations of a limited liability company are now referred to as its “Company Agreement.”⁴⁸ Other changes include the shift in the titles of filings from “Application for Certificate of Authority to Transact Business”⁴⁹ to “Application for Registration,”⁵⁰ from “Articles of Amendment”⁵¹ to “Certificate of Amendment,”⁵² and from “Articles of Dissolution”⁵³ to “Certificate of Termination.”⁵⁴ Under the TBOC, a “domestic entity” is a corporation, partnership, LLC or other entity formed under the TBOC or whose internal affairs are governed by the TBOC,⁵⁵ and a “foreign entity” is an organization that is formed under and the internal affairs are governed by the laws of a jurisdiction other than Texas.⁵⁶ A Texas entity that is formed by a filing with the Secretary of State is called a “filing entity” and includes a corporation, LP, LLC, professional association and a real estate investment trust.⁵⁷ “Person” was initially defined by reference to § 311.005 of the Government Code, and is now defined in TBOC § 1.002(69-b).⁵⁸

(b) Certificate of Formation. In addition to changing the name of the formation document required of entities organizing in Texas, the TBOC has made small alterations to its required contents as well. For example, previously such a document had to state the entity’s period of duration. The TBOC eliminates this requirement, except for entities that will not exist perpetually.⁵⁹ However, it adds the requirement that the document state what type of entity shall be formed upon its filing.⁶⁰ Other requirements differ slightly for each entity.⁶¹

(c) Filing Procedures. In addition to changing the form of the document required to organize a Texas business entity, the TBOC streamlined the filing fees for a number of documents.⁶² For example, the filing fees for a certificate of formation for all domestic entities

⁴⁷ TBOC § 1.002(6). Comparable documents under pre-TBOC law include a corporation’s Articles of Incorporation, an LLC’s Articles of Organization, and a limited partnership’s Certificate of Limited Partnership.

⁴⁸ See TBOC § 101.052.

⁴⁹ See TBCA art. 8.01.

⁵⁰ See TBOC § 9.004.

⁵¹ See TBCA art. 4.04.

⁵² See TBOC § 3.053.

⁵³ See TBCA art. 6.06.

⁵⁴ See TBOC § 11.101.

⁵⁵ TBOC § 1.002(18).

⁵⁶ TBOC § 1.002(28).

⁵⁷ TBOC § 1.002(22).

⁵⁸ TBOC § 1.002(69-b) defines “person” as follows:

(69-b) “Person” means an individual or a corporation, partnership, limited liability company, business trust, trust, association, or other organization, estate, government or governmental subdivision or agency, or other legal entity.

⁵⁹ TBOC §§ 3.003, 3.005, and the related Revisor’s Report, *supra* note 20.

⁶⁰ TBOC § 3.005 and the related Revisor’s Report, *supra* note 20.

⁶¹ TBOC § 3.005 provides the minimum requirements for all Certificates of Formation, and the sections immediately thereafter specify the additional information required for each type of entity.

⁶² See TBOC Chapter 4, Subchapter D.

are now set forth in TBOC Chapter Four, Subchapter D.⁶³ Additionally, the TBOC now authorizes a filing fee of \$50 for the pre-clearance of any document, whereas before, the Secretary of State was only authorized to charge such fee for pre-clearance of limited partnership documents.⁶⁴ Another procedural change is that previously, when certain entities sent in their formation document (i.e., articles of incorporation for a regular corporation), the Secretary of State would send back an official document in response (i.e., a certificate of incorporation).⁶⁵ Now, however, upon receipt of a certificate of formation, the Secretary of State may simply return a written acknowledgement of the filing, and is not required to issue any additional certificates or documents.⁶⁶ Filings are generally effective when filed, not when the Secretary of State acknowledges them.⁶⁷ Additionally, documents with delayed effective dates may now be abandoned at any time prior to effectiveness.⁶⁸

(d) Entity Names. The TBOC relaxes the requirements for indicating the business entity form in the entity's official name further than even the most recent revisions to pre-TBOC law. A business's name must still indicate the business's entity form, but with greater flexibility regarding placement and abbreviation thereof than was previously permitted.⁶⁹ For example, previously, a limited partnership had to include in its name "limited," "limited partnership," "L.P.," or "Ltd.," and the name could not contain the name of a limited partner except under limited circumstances.⁷⁰ Now, however, limited partnerships need only contain "limited," "limited partnership," or "an abbreviation of that word or phrase" in their names, without any restrictions on the inclusion of a limited partner's name.⁷¹ Under the TBOC an LLP is called a limited liability partnership rather than a "registered" limited liability partnership as it was known under TRPA.⁷²

(e) Governance. Subject to contrary provisions in an entity's governing documents, the TBOC now permits the removal of officers with or without cause, doing away with the requirement in much of the source law that such removal must be in the entity's best interests.⁷³ Also, the TBOC extends to all types of domestic entities the right for officers and directors to rely on opinions, reports, and statements given by certain people in the execution of their duties.⁷⁴ Further, it clarifies, as a default rule, that governing persons of domestic entities, other

⁶³ See *id.* and the related Revisor's Report, *supra* note 20.

⁶⁴ TBOC § 4.151 and the related Revisor's Report, *supra* note 20.

⁶⁵ See TBCA art. 3.03.

⁶⁶ See TBOC § 4.002 the related Revisor's Report, *supra* note 20.

⁶⁷ TBOC § 4.051.

⁶⁸ TBOC § 4.057.

⁶⁹ See TBOC §§ 5.054-5.063.

⁷⁰ TRLPA § 1.03.

⁷¹ TBOC §§ 5.055, 153.102 and the related Revisor's Report, *supra* note 20.

⁷² TRPA § 3.08; TBOC §§ 1.002(48) and 152.801-152.805.

⁷³ TBOC § 3.104; TBCA art. 2.43; TNPCA art. 1396-2.21.

⁷⁴ TBOC § 3.102. This default right previously existed for certain entities (*see, e.g.*, TBCA art. 2.41D and TNPCA art. 1396-2.28(B)), but not for partnerships or LLCs. See TBOC § 3.102 and the related Revisor's Report, *supra* note 20.

than limited partnerships, have the right to inspect the entity's books and records in connection with their duties.⁷⁵

Additionally, the TBOC expands the permissible methods of holding required meetings to encompass the broad spectrum of technology now available by which such meetings may be conducted.⁷⁶ Moreover, it adds safeguards that must be followed when using such technology to assure that only authorized persons are able to vote at such meetings.⁷⁷

(f) **Construction.** The TBOC incorporates the provisions of the Code Construction Act⁷⁸ to assist in its interpretation.⁷⁹ The Code Construction Act includes such useful aids as definitions of commonly used terms, basic rules of construction, the order of authority for conflicting statutes, and statutory savings provisions. The rules of the Code Construction Act are general in nature, and are intended to fill in any gaps left by the more specific rules of construction provided within the TBOC applicable to particular entity types.

(g) **Transition Rules.**⁸⁰ As previously stated, during the transition period between January 1, 2006 and January 1, 2010, entities which were formed in Texas prior to the TBOC's effective date but not opting in to TBOC governance continued to be governed by the old Texas statutes. During that period, such entities could continue to make filings with the Texas Secretary of State in the same manner as before the TBOC effective date, without any need to conform to the new filing requirements of the TBOC or adjust the nomenclature used.⁸¹ However, limited liability partnerships were only entitled to continue following the registration requirements of the TRPA and TRLPA until their existing registrations expired,⁸² at which point they were required to renew under the TBOC (although until January 1, 2010 they continued to be substantively governed by the TRPA and TRLPA).

1.4. Business Combinations and Conversions.

1.4.1. Business Combinations Generally. A business combination involves one entity or its owners acquiring another entity, its assets or ownership interests. A business combination can be effected by a merger, acquisition of shares or other ownership interests, or an acquisition of the assets of the acquired entity.

(a) **Merger.** Texas law allows corporations, LLCs and partnerships to merge with each other (e.g., a limited partnership can merge into a corporation).⁸³ Detailed provisions

⁷⁵ TBOC § 3.152 and the related Revisor's Report, *supra* note 20.

⁷⁶ See TBOC § 6.002.

⁷⁷ TBOC § 6.002.

⁷⁸ TEX. GOV'T CODE ANN. § 311 (Vernon Supp. 2015).

⁷⁹ TBOC § 1.051.

⁸⁰ For more detailed rules governing the transition period, see TBOC Title 8.

⁸¹ To illustrate, a corporation that was incorporated in Texas prior to January 1, 2006 could still amend its Articles of Incorporation by filing Articles of Amendment to its Articles of Incorporation, rather than a Certificate of Amendment until January 1, 2010. The Articles of Amendment would only need to conform to the current version of the TBCA until January 1, 2010.

⁸² TBOC § 402.001(b).

⁸³ TBCA art. 5.01, § A; LLC Act § 10.01, § A; TRLPA § 2.11; TRPA § 9.02; TBOC § 10.001.

appearing in the TBOC and its predecessor statutes provide the mechanics of adopting a plan of merger, obtaining owner approval, filing with the Secretary of State, and protecting creditors.

(b) Share Exchange. A business combination may be effected by a transfer of shares or other ownership interests in which either (i) all of the owners agree to the sale or exchange of their interests or (ii) there is a statutory share or interest exchange pursuant to a plan of exchange approved by the vote of the owners, which may be less than unanimous but is binding on all, pursuant to statute or the entity documents.⁸⁴ The TBOC and its respective predecessor entity statutes – the TBCA, the LLC Act, the TRLPA and the TRPA – each have provisions providing the mechanics of adopting a plan of exchange, obtaining owner approval and filing with the Secretary of State.⁸⁵

(c) Asset Sale. A sale or exchange of all or substantially all of the assets of an entity may require approval of the owners, depending on the nature of the transaction, the entity’s organization documents and applicable state law.⁸⁶ In most states, shareholder approval of an asset sale has historically been required when a corporation is selling all or substantially all of its assets. The Delaware courts have used both “qualitative” and “quantitative” tests in interpreting the phrase “substantially all,” as it is used in Section 271 of the Delaware General Corporation Law (“DGCL”), which requires stockholder approval for a corporation to “sell, lease or exchange all or substantially all of its property and assets.”⁸⁷

⁸⁴ TBCA art. 5.02 § A; LLC Act §§ 10.01, 10.06; TRLPA § 2.11; TRPA § 9.03; TBOC § 10.051.

⁸⁵ TBCA art. 5.02 § A; LLC Act §§ 10.01, 10.06; TRLPA § 2.11; TRPA § 9.03; TBOC §§ 10.151-10.153.

⁸⁶ See TBCA arts. 5.09 and 5.10; TBOC § 10.251. See also Byron F. Egan and Curtis W. Huff, *Choice of State of Incorporation - Texas versus Delaware: Is It Now Time To Rethink Traditional Notions?*, 54 SMU L. Rev. 249, 287-288 (Winter 2001); Byron F. Egan and Amanda M. French, *1987 Amendments to the Texas Business Corporation Act and Other Texas Corporation Laws*, 25 Bull. of Section on Corp., Banking & Bus. L. 1, 11-12 (No. 1, Sept. 1987).

⁸⁷ See *Gimbel v. Signal Co., Inc.*, 316 A.2d 599 (Del. Ch. 1974) (assets representing 41% of net worth but only 15% of gross revenues held not to be “substantially all”); *Katz v. Bregman*, 431 A.2d 1274 (Del. Ch. 1981) (51% of total assets, generating approximately 45% of net sales, held to be “substantially all”); and *Thorpe v. CERBCO, Inc.*, 676 A.2d 436 (Del. 1996) (sale of subsidiary with 68% of assets, which was primary income generator, held to be “substantially all”); Court noted that seller would be left with only one operating subsidiary, which was marginally profitable). See also *Hollinger Inc. v. Hollinger Int’l, Inc.*, 858 A.2d 342 (Del. Ch. 2004), *appeal refused*, 871 A.2d 1128 (Del. 2004), in which (A) the sale of assets by a subsidiary with approval of its parent corporation (its stockholder), but not the stockholders of the parent, was alleged by the largest stockholder of the parent to contravene DGCL § 271; (B) without reaching a conclusion, the Chancery Court commented in dicta that “[w]hen an asset sale by the wholly owned subsidiary is to be consummated by a contract in which the parent entirely guarantees the performance of the selling subsidiary that is disposing of all of its assets and in which the parent is liable for any breach of warranty by the subsidiary, the direct act of the parent’s board can, without any appreciable stretch, be viewed as selling assets of the parent itself” (the Court recognized that the precise language of DGCL § 271 only requires a vote on covered sales by a corporation of “its” assets, but felt that analyzing dispositions by subsidiaries on the basis of whether there was fraud or a showing that the subsidiary was a mere alter ego of the parent as suggested in *Leslie v. Telephonics Office Technologies, Inc.*, 1993 WL 547188 (Del. Ch., Dec. 30, 1993) was too rigid); and (C) examining the consolidated economics of the subsidiary level sale, the Chancery Court held (1) that “substantially all” of the assets should be literally read, commenting that “[a] fair and succinct equivalent to the term ‘substantially all’ would be ‘essentially everything’”, notwithstanding past decisions that have looked at sales of assets around the 50% level, (2) that the principal inquiry was whether the assets sold were “quantitatively vital to the operations of” seller (the

Difficulties in determining when a shareholder vote is required in Delaware led Texas to adopt a bright line test. TBCA articles 5.09 and 5.10 provided, in essence, that shareholder approval is required under Texas law only if it is contemplated that the corporation will cease to conduct any business following the sale of assets.⁸⁸ Under TBCA article 5.10, a sale of all or substantially all of a corporation's property and assets must be approved by the shareholders (and shareholders who voted against the sale could perfect appraisal rights). TBCA article 5.09(A) provided an exception to the shareholder approval requirement if the sale is "in the usual and regular course of the business of the corporation," and a 1987 amendment added section B to article 5.09 providing that a sale is

in the usual and regular course of business if, [after the sale,] the corporation shall, directly or indirectly, either continue to engage in one or more businesses or

business sold represented 57.4% of parent's consolidated EBITDA, 49% of its revenues, 35.7% of the book value of its assets, and 57% of its asset values based on bids for the two principal units of the parent), (3) that the parent had a remaining substantial profitable business after the sale (the Chancery Court wrote: "if the portion of the business not sold constitutes a substantial, viable, ongoing component of the corporation, the sale is not subject to Section 271," quoting BALOTTI AND FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS, §10.2 at 10-7 (3rd ed. Supp. 2004), and (4) that the "qualitative" test of *Gimbel* focuses on "factors such as the cash-flow generating value of assets" rather than subjective factors such as whether ownership of the business would enable its managers to have dinner with the Queen. See Morton and Reilly, *Clarity or Confusion? The 2005 Amendment to Section 271 of the Delaware General Corporation Law*, X Deal Points – The Newsletter of the Committee on Negotiated Acquisitions 2 (Fall 2005); see also Subcommittee on Recent Judicial Developments, ABA Negotiated Acquisitions Committee, *Annual Survey of Judicial Developments Pertaining to Mergers and Acquisitions*, 60 Bus. Law. 843, 855-58 (2005); BALOTTI AND FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS, §10.2 (3rd ed. Supp. 2009). To address the uncertainties raised by dicta in Vice Chancellor Strine's opinion in *Hollinger*, DGCL § 271 was amended effective August 1, 2005 to add a new subsection (c) which provides as follows:

(c) For purposes of this section only, the property and assets of the corporation include the property and assets of any subsidiary of the corporation. As used in this subsection, "subsidiary" means any entity wholly-owned and controlled, directly or indirectly, by the corporation and includes, without limitation, corporations, partnerships, limited partnerships, limited liability partnerships, limited liability companies, and/or statutory trusts. Notwithstanding subsection (a) of this section, except to the extent the certificate of incorporation otherwise provides, no resolution by stockholders or members shall be required for a sale, lease or exchange of property and assets of the corporation to a subsidiary.

This amendment answered certain questions raised by *Hollinger*, but raised or left unanswered other questions (e.g., (i) whether subsection (c) applies in the case of a merger of a subsidiary with a third party even though literally read DGCL § 271 does not apply to mergers, (ii) what happens if the subsidiary is less than 100% owned, and (iii) what additional is meant by the requirement that the subsidiary be wholly "controlled" as well as "wholly owned"). See Morton and Reilly, *Clarity or Confusion? The 2005 Amendment to Section 271 of the Delaware General Corporation Law*, X Deal Points – The Newsletter of the Committee on Negotiated Acquisitions 2 (Fall 2005); cf. *Weinstein Enterprises, Inc. v. Orloff*, 870 A.2d 499 (Del. 2005) for a discussion of "control" in the context of a DGCL § 220 action seeking inspection of certain documents in the possession of a publicly held New York corporation of which the defendant Delaware corporation defendant was a 45.16% stockholder.

⁸⁸ See Byron F. Egan and Curtis W. Huff, *Choice of State of Incorporation --Texas versus Delaware: Is it Now Time to Rethink Traditional Notions?*, 54 SMU L. REV. 249, 287-290 (Winter 2001).

apply a portion of the consideration received in connection with the transaction to the conduct of a business in which it engages following the transaction.⁸⁹

TBOC sections 21.451 and 21.455 carry forward TBCA articles 5.09 and 5.10.

The Texas partnership statutes do not contain any analogue to TBCA articles 5.09 and 5.10 and the parallel TBOC provisions applicable to corporations. They leave any such requirement to the partnership agreement or another contract among the owners of the entity.⁹⁰ The Texas LLC Statutes reach a similar result, but under the TBOC it would be necessary to affirmatively provide that no owner vote is required to approve a sale of all or substantially all of the assets of the LLC.⁹¹

An important reason for structuring an acquisition as an asset transaction is the desire on the part of a buyer to limit its responsibility for liabilities of the seller, particularly unknown or contingent liabilities. Unlike a stock purchase or statutory combination, where the acquired corporation retains all of its liabilities and obligations, known and unknown, the buyer in an asset purchase has an opportunity to determine which liabilities of the seller it will contractually assume. In certain other jurisdictions, the purchase of an entire business where the shareholders of the seller become shareholders of the buyer can cause a sale of assets to be treated as a

⁸⁹ In *Rudisill v. Arnold White & Durkee, P.C.*, 148 S.W.3d 556 (Tex. App.—Houston [14th Dist.] 2004, no pet.), the 1987 amendment to art. 5.09 was applied literally. The *Rudisill* case arose out of the combination of Arnold White & Durkee, P.C. (“AWD”) with another law firm, Howrey & Simon (“HS”). The combination agreement provided that all of AWD’s assets other than those specifically excluded (three vacation condominiums, two insurance policies and several auto leases) were to be transferred to HS in exchange for a partnership interest in HS, which subsequently changed its name to Howrey Simon Arnold & White, LLP (“HSAW”). In addition, AWD shareholders were eligible individually to become partners in HSAW by signing its partnership agreement, which most of them did.

For business reasons, the AWD/HS combination was submitted to a vote of AWD’s shareholders. Three AWD shareholders submitted written objections to the combination, voted against it, declined to sign the HSAW partnership agreement, and then filed an action seeking a declaration of their entitlement to dissenters’ rights or alternate relief. The court accepted AWD’s position that these shareholders were not entitled to dissenters’ rights because the sale was in the “usual and regular course of business” as AWD continued “to engage in one or more businesses” within the meaning of TBCA art. 5.09B, writing that “AWD remained in the legal services business, at least indirectly, in that (1) its shareholders and employees continued to practice law under the auspices of HSAW, and (2) it held an ownership interest in HSAW, which unquestionably continues directly in that business.” The court further held that AWD’s obtaining shareholder approval when it was not required by TBCA art. 5.09 did not create appraisal rights, pointing out that appraisal rights are available under the statute only “*if special authorization of the shareholders is required.*” See Subcommittee on Recent Judicial Developments, *ABA Negotiated Acquisitions Committee, Annual Survey of Judicial Developments Pertaining to Mergers and Acquisitions*, 60 Bus. Law. 843, 855-60 (2005).

⁹⁰ See TBOC § 153.152.

⁹¹ TBOC § 1.002(32) defines “fundamental business transaction” to include a “sale of all or substantially all of the entity’s assets” and TBOC § 101.356 requires a member vote to approve any fundamental business transaction, although TBOC § 101.052 would allow the parties to include in the company agreement provisions that trump this TBOC requirement.

common law “*de facto merger*,” which would result in the buyer becoming responsible as a matter of law for seller liabilities which the buyer did not contractually assume.⁹²

1.4.2. De Facto Merger Repealed. Texas legislatively repealed the *de facto* merger doctrine in TBCA article 5.10B, which provides in relevant part that “[a] disposition of any, all, or substantially all, of the property and assets of a corporation . . . (1) is not considered to be a merger or conversion pursuant to this Act or otherwise; and (2) except as otherwise expressly provided by another statute, does not make the acquiring corporation, foreign corporation, or other entity responsible or liable for any liability or obligation of the selling corporation that the acquiring corporation, foreign corporation, or other entity did not expressly assume.”⁹³ TBOC section 10.254 carries forward TBCA article 5.10B and makes it applicable to all domestic entities.

1.4.3. Divisive Mergers. TBOC § 10.001 *et seq.* authorizes a corporation, partnership or LLC to effect a “divisive merger” by which a single corporation would adopt a plan of merger pursuant to which it divides its assets and liabilities among one or more new or existing entities (a “Divisive Merger”). Thus, a single corporation could adopt a plan of merger pursuant to which it would create a new entity and divide its assets and liabilities between itself and the new entity.

The Texas Divisive Merger analysis begins with TBOC § 1.002(55) which defines “merger” to mean “(A) the division of a domestic entity into two or more new domestic entities or other organizations or into a surviving domestic entity and one or more new domestic or foreign entities or non-code organizations”.⁹⁴ A Divisive Merger under the TBOC can involve any combination of corporations, partnerships or LLCs, including professional entities, but all of them would need to be organized under the TBOC or the laws of another state which permits Divisive Mergers as the entity statutes of most other states do not authorize Divisive Mergers.⁹⁵

⁹² See *Knapp v. N. Amer. Rockwell Corp.*, 506 F.2d 361 (3d Cir. 1974); *Philadelphia Electric Co. v. Hercules, Inc.*, 762 F.2d 303 (3d Cir. 1985); *SmithKline Beecham Corp. v. Rohm and Haas Corp.*, 89 F.3d 154 (3d Cir. 1996); *Cargo Partner AG v. Albatrans Inc.*, 352 F.3d 41 (2d Cir. 2003).

⁹³ In *C.M. Asfahl Agency v. Tensor, Inc.*, 135 S.W.3d 768, 780-81 (Tex.App.—Houston [1st Dist.] 2004), a Texas Court of Civil Appeals, quoting TBCA art. 5.10(B)(2) and citing two other Texas cases, wrote:

This transaction was an asset transfer, as opposed to a stock transfer, and thus governed by Texas law authorizing a successor to acquire the assets of a corporation without incurring any of the grantor corporation’s liabilities unless the successor expressly assumes those liabilities. [citations omitted] Even if the Agency’s sales and marketing agreements with the Tensor parties purported to bind their ‘successors and assigns,’ therefore, the agreements could not contravene the protections that article 5.10(B)(2) afforded Allied Signal in acquiring the assets of the Tensor parties unless Allied Signal expressly agreed to be bound by Tensor parties’ agreements with the Agency.

See Byron F. Egan & Curtis W. Huff, *Choice of State of Incorporation --Texas versus Delaware: Is it Now Time to Rethink Traditional Notions*, 54 SMU Law Review 249, 287-290 (Winter 2001).

⁹⁴ See Curtis W. Huff, *The New Texas Business Corporation Act Merger Provisions*, 21 St. Mary’s L.J. 109 (1989).

⁹⁵ Arizona is the only state other than Texas whose laws appear to permit a corporation to merge into itself to create another entity. See Arizona Revised Statutes § 10-1101 *et seq.* (2015); Steven A. Bank, *Taxing Divisive and Disregarded Mergers*, 34 Ga. L. Rev. 1523, 1529 (Summer 2000).

The plan of merger must provide, among other things, (1) the manner and basis for allocating and vesting the property of the parties and (2) the manner and basis of allocating each liability and obligation of the parties or making adequate provision for the payment and discharge thereof. Additionally, the plan of merger should specifically set forth the mechanism under which contingent assets and contingent liabilities of the parties are to be allocated and satisfied or provided for. This will be an important aspect of the plan of merger, as TBOC § 10.008(a) generally provides that, if properly allocated in the plan of merger, all assets and liabilities of the parties to the merger will be allocated (subject to existing contracts, liens and encumbrances) among the surviving entities in the manner provided in the plan, and not to any other party.⁹⁶ If, however, the plan of merger fails to provide for the allocation or vesting of any particular item of property or any liability or obligation of any party to the merger, TBOC § 10.008(b) provides that “the unallocated property is owned in undivided interest by, or the liability or obligation is the joint and several liability and obligation of, each of the surviving and new organizations, pro rata to the total number of surviving and new organizations resulting from the merger.”

A Divisive Merger under the TBOC may alter and reduce the pool of assets to which a creditor may look to for repayment. In this regard, if a claim of a creditor of one entity in a Divisive Merger is allocated to a different or new entity in the merger, that creditor will generally only be entitled to look to the entity to which its claim is allocated and not to each surviving entity.⁹⁷ The creditor, thus, will continue to possess all the rights otherwise available to it under law and contract, including all security interests in the property of the debtor securing the payment of the creditor’s claim.⁹⁸

⁹⁶ TBOC § 10.008(a)(3) provides that, upon the effectiveness of a merger, “each surviving or new domestic organization to which a liability or obligation is allocated under the plan of merger is the primary obligor for the liability or obligation, and, except as otherwise provided by the plan of merger or by law or contract, no other party to the merger, other than a surviving domestic entity or non-code organization liable or otherwise obligated at the time of the merger, and no other new domestic entity or non-code organization created under the plan of merger is liable for the debt or other obligation...”

⁹⁷ This result follows from the express language in TBOC §§ 10.008(a)(3) and (4), which provide that, except as provided in the plan of merger or otherwise provided by law or contract, the party to which an obligation is allocated will be the party primarily liable for that obligation and, except as otherwise provided by the plan of merger, or by law or by contract, no other party is liable therefor.

⁹⁸ See TBOC § 10.901 (providing that “[t]his code does not affect, nullify, or repeal...any right or rights of creditor[s] under existing law”). Principal among the laws available to protect creditors in mergers with multiple survivors are the Uniform Fraudulent Transfer Act, which has been adopted in Texas with modifications as Tex. Bus. & Com. Code Ann. §§ 24.001 – 013 (the “UFTA”), and the United States Bankruptcy Code of 1978, as amended (the “Bankruptcy Code”). See Mark Torabi, *Judgment Day: Identifying Fraudulent Transfers Before It’s Too Late*, 78 Tex. B. J. 358 (May 2015). Although the specific standards vary between the UFTA and the Bankruptcy Code, a transfer or conveyance of assets or the incurrence of an obligation effected by means of a merger is a “transfer” thereunder as the term “transfer” is defined to include “every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with” an asset or an interest in an asset. UFTA § 24.002(12); Bankruptcy Code § 101.54. Although a merger will not involve a “transfer” of assets in the traditional sense, and in fact TBOC § 10.008(a)(2)(C) of the TBOC provides that the allocation of assets in a merger occurs “without transfer or assignment having occurred,” the allocation of assets and liabilities in a merger likely constitutes both a “transfer” and “conveyance” of assets under both the letter and spirit of the UFTA and the Bankruptcy Code. Thus, a merger will generally be subject to challenge as a fraudulent transfer or conveyance under three circumstances: First, if the debtor transfers assets or incurs an obligation with the

1.4.4. Conversions.

(a) General. Texas law allows corporations, LLCs and partnerships to convert from one form of entity into another without going through a transfer of assets or merger.⁹⁹ When a conversion takes effect after Board and shareholder approval and a filing with the Secretary of State, the converting entity continues to exist without interruption in the form of the converted entity with all of the rights, titles and interests of the converted entity without any transfer or assignment having occurred.¹⁰⁰ A conversion is not a combination of entities; rather, it is only a change in the statutory form and nature of an existing entity. Additionally, a conversion involves only one entity and does not involve any change in the ownership of that entity, although it may change the rights of the owners.¹⁰¹ The TBOC and its source Texas entity statutes each have provisions relating to the mechanics of adopting a plan of conversion, obtaining owner approval,

intent to “hinder, delay or defraud” creditors; Second, if the debtor transfers assets or incurs an obligation without receiving “reasonably equivalent value” or “fair consideration” and the debtor (1) was engaged or about to engage in a business or transaction for which its remaining assets were unreasonably small in relationship to the business or transaction conducted or contemplated to be conducted or (2) intended to incur, or believed that it would incur, debts beyond its ability to pay as they become due and mature; and Third, if the transfer of assets by the debtor or the incurrence of the obligation by the debtor was made without “reasonably equivalent value” or “fair consideration” and the debtor was “insolvent.” In each of these cases (if it were deemed a transfer) the creditor of the debtor or a trustee in bankruptcy could seek various remedies against the debtor and the transferee of assets, including: (1) avoidance of the transfer or obligation, (2) an attachment or other proceeding against the assets transferred, (3) an injunction from a further disposition of the assets transferred, and (4) an appointment of a receiver. Under the foregoing analysis, the allocation of the claim of a creditor of a constituent entity may allow such creditor to challenge the divisive merger described above if: (1) allocation of the liability occurs without reasonably equivalent value or fair consideration (i.e., without the allocation of a corresponding asset or method of providing for such liability) and the entity to which the liability is allocated is insolvent, has an unreasonably small amount of assets in relationship to the business or transactions conducted or contemplated to be conducted by it or it intended to incur or believed that it would incur debts beyond its ability to pay them as they become due and absolute, or (2) the allocation was effected with the intent to hinder, delay or defraud any creditor. In any of the above situations, such creditor may exercise all of its available remedies under the UFTA and the Bankruptcy Code, including seeking the avoidance of the transfer or the allocation of the liability, an attachment of the allocated assets and any other appropriate equitable remedy. The remedy most likely granted, however, would be for the assets of all the entities to the merger to become subject to the claims of the creditors of the other entities to the merger. *See* Comment to VI. Selected Asset Purchase Agreement Provisions – Section 3.32 Solvency.

⁹⁹ TBCA Part Five; TBOC Chapter 10, Subchapter C; *cf.* ABA Committee on Corporate Laws, *Changes in the Model Business Corporation Act Relating to Domestication and Conversion – Final Adoption*, 58 Bus. Law 219 (Nov. 2002).

¹⁰⁰ TBOC § 10.106.

¹⁰¹ *See Grohman v. Kahlig*, 318 S.W.3d 882 (Tex. 2010), in which the Texas Supreme Court held that the conversion of two corporations into limited partnerships did not violate the terms of a security agreement covering shares of stock in the corporations that required the pledgor not to “sell, transfer, lease or otherwise dispose of the Collateral or any interest therein” without the pledgor’s consent, and not to “allow the Collateral to become wasted or destroyed,” because the pledged shares of stock were converted to limited partnership units and the definition of “Collateral” in the security agreement encompassed “all replacements, additions, and substitutions,” and the shares of stock that were canceled in the conversion were first replaced with limited partnership units that represented the same interest in the businesses; thus, the Collateral was not transferred, and the pledgee’s security interest was not impaired.

filing with the Secretary of State, and protecting creditors. Those Texas statutes and the federal income tax consequences of conversions are summarized below.

(b) Texas Statutes. Under the conversion provisions of Texas law,¹⁰² a Texas corporation may convert into another corporation or other entity if (i) the conversion is approved by its Board and shareholders in the same manner as a merger in which the corporation is not the surviving entity would be approved; (ii) the conversion is consistent with the laws under which the resulting entity is to be governed; (iii) shareholders will have a comparable interest in the resulting entity unless a shareholder exercises his statutory dissenter's rights or otherwise agrees; (iv) no shareholder will become personally liable for the obligations of the resulting entity without his consent; (v) the resulting entity is a new entity formed as a result of the conversion rather than an existing entity (which would be a merger); and (vi) the resulting entity continues to own all of the rights, titles and interests of the converting entity without any transfer or assignment having occurred.¹⁰³ Partnerships, limited partnerships, and LLCs are afforded comparable rights.¹⁰⁴

¹⁰² TBCA arts. 5.17, 5.18, 5.19 and 5.20; TBOC §§ 10.101-10.151, 10.154-10.203.

¹⁰³ TBOC § 10.101. Under TBOC § 10.106, when a conversion takes effect upon the filing of a certificate of conversion with the Secretary of State after following the above procedures:

- (1) the converting entity shall continue to exist, without interruption, but in the organizational form of the converted entity rather than in its prior organizational form;
- (2) all rights, titles, and interests to all real estate and other property owned by the converting entity shall continue to be owned by the converted entity in its new organizational form without reversion or impairment, without further act or deed, and without any transfer or assignment having occurred, but subject to any existing liens or other encumbrances thereon;
- (3) all liabilities and obligations of the converting entity shall continue to be liabilities and obligations of the converted entity in its new organizational form without impairment or diminution by reason of the conversion;
- (4) all rights of creditors or other parties with respect to or against the prior interest holders or other owners of the converting entity in their capacities as such in existence as of the effective time of the conversion will continue in existence as to those liabilities and obligations and may be pursued by such creditors and obligees as if the conversion had not occurred;
- (5) a proceeding pending by or against the converting entity or by or against any of its owners or members in their capacities as such may be continued by or against the converted entity in its new organizational form and by or against the prior owners or members without any need for substitution of parties;
- (6) the ownership or membership interests in the converting entity that are to be converted into ownership or membership interests in the converted entity as provided in the plan of conversion shall be so converted, and the former holders of ownership or membership interests in the converting entity shall be entitled only to the rights provided in the plan of conversion or rights of dissent and appraisal under the TBOC;
- (7) if, after the effectiveness of the conversion, an owner or member of the converted entity would be liable under applicable law, in such capacity, for the debts or obligations of the entity, such owner or member shall be liable for the debts and obligations of the entity that existed before the conversion takes effect only to the extent that such owner or member: (a) agreed in writing to be liable for such debts or obligations, (b) was liable under applicable law, prior to the effectiveness of the conversion, for such debts or obligations, or (c) by becoming an owner or member of the

Under the TBOC a converting entity may elect to continue its existence in its current organizational form and jurisdiction of formation in connection with its conversion under TBOC Chapter 10.¹⁰⁵ This election, which is intended to afford foreign entities a means to do business in the U.S. while avoiding adverse foreign tax consequences, is only available to a domestic entity of one organizational form that is converting into a non-U.S. entity of the same organizational form or a non-U.S. entity of one organizational form converting into a domestic entity of the same organizational form. The permitted election must be adopted and approved as part of the plan of conversion for the converting entity and permitted by, or not prohibited by or inconsistent with, the laws of the applicable non-U.S. jurisdiction.¹⁰⁶

converted entity becomes liable under applicable law for existing debts and obligations of the converted entity; and

- (8) if the converted entity is one not governed by the TBOC, then it is considered (a) to have appointed the Texas Secretary of State as its registered agent for purposes of enforcing any obligations or dissenters' rights and (b) to have agreed to promptly pay the dissenting members or owners of the converting entity any amounts owed under the TBOC.

See also TBCA art. 5.20.

¹⁰⁴ *See* TBOC § 10.101. The comparable provisions for such entities governed by pre-TBOC law are found for LLCs at LLC Act §§ 10.08-10.11, for limited partnerships at TRLPA § 2.15, and for general partnerships at TRPA §§ 9.01, 9.05 and 9.06.

¹⁰⁵ TBOC § 10.1025 as added in the 2009 Legislative Session by 2009 S.B. 1442 §§ 15-18. In a conversion and continuance transaction under new TBOC § 10.109, the converting entity continues to exist both in its current organizational form and jurisdiction of formation and in the same organizational form in the new jurisdiction of formation, and as a single entity subject to the laws of both jurisdictions. The property interests, liabilities and obligations of the entity remain unchanged. For a conversion and continuance transaction, the certificate of conversion must be titled a "certificate of conversion and continuance" and must include a statement certifying that the converting entity is electing to continue its existence in its current organizational form and jurisdiction of formation. *See* Byron F. Egan, *Choice of Entity Alternatives* (May 28, 2010), available at <http://www.jw.com/site/jsp/publicationinfo.jsp?id=1396>, which at Appendix D describes (i) 2009 S.B. 1442 by Sen. Troy Fraser (generally updating the TBOC), available at <http://www.legis.state.tx.us/BillLookup/Text.aspx?LegSess=81R&Bill=SB1442>, and (ii) 2009 H.B. 1787 by Rep. Burt Solomons (amending TBOC provisions pertaining to the designation of registered agents for service of process), available at <http://www.legis.state.tx.us/BillLookup/Text.aspx?LegSess=81R&Bill=HB1787>.

Delaware General Corporation Law ("DGCL") § 388 allows non-U.S. corporations and other entities to move to Delaware by filing a certificate of domestication, together with a certificate of incorporation with the Delaware Secretary of State. Upon filing these documents, the corporation becomes "domesticated" in Delaware, which means that the corporation becomes a Delaware corporation subject to all the provisions and entitled to all the benefits of the Delaware law governing corporations. A domesticated corporation is deemed to have been in existence since the beginning of its existence in the jurisdiction in which it was first formed, rather than the time it domesticated in Delaware. DGCL § 388 contemplates the movement of a corporation or other entity to Delaware on a permanent basis. DGCL § 388 contemplates a continuation, as opposed to a rebirth. DGCL § 388(e) specifically provides that a domestication "shall not be deemed to affect any obligations or liabilities of the non-United States entity incurred prior to its domestication."

¹⁰⁶ Even though the converting entity continues to exist in the non-U.S. jurisdiction (as well as in Texas), the entity would not be required to qualify to do business as a foreign entity under TBOC Chapter 9 (Foreign Entities) after its conversion and continuance. TBOC § 10.1025 as added in the 2009 Legislative Session by 2009 S.B. 1442 §§ 15-18. *See* Byron F. Egan, *Choice of Entity Alternatives* (May 28, 2010), available at <http://www.jw.com/site/jsp/publicationinfo.jsp?id=1396>, which at Appendix D describes (i) 2009 S.B. 1442 by Sen. Troy Fraser (generally updating the TBOC), available at <http://www.legis.state.tx.us/BillLookup/Text.aspx?LegSess=81R&Bill=SB1442>, and (ii) 2009 H.B. 1787

(c) Effect on State Licenses. The Texas Attorney General has issued an opinion to the effect that “[w]hen a corporation converts to another type of business entity in accordance with the TBCA, as a general rule a state license held by the converting corporation continues to be held by the new business entity . . . subject to the particular statutory requirements or regulations of the specific state entity that issued the license.”¹⁰⁷

1.5. Joint Ventures. A joint venture is a vehicle for the development of a business opportunity by two or more entities acting together,¹⁰⁸ and will exist if the parties have: (1) a community of interest in the venture, (2) an agreement to share profits; (3) an agreement to share losses, and (4) a mutual right of control or management of the venture.¹⁰⁹ A joint venture may be structured as a corporation, partnership, LLC, trust, contractual arrangement,¹¹⁰ or any combination of such entities and arrangements.¹¹¹ Structure decisions for a particular joint

by Rep. Burt Solomons (amending TBOC provisions pertaining to the designation of registered agents for service of process), available at <http://www.legis.state.tx.us/BillLookup/Text.aspx?LegSess=81R&Bill=HB1787>.

¹⁰⁷ Tex. Att’y Gen. Op. No. JC-0126 (1999).

¹⁰⁸ See Byron F. Egan, *Joint Venture Governance and Business Opportunity Issues* (Oct. 15, 2015), available at <http://www.jw.com/publications/article/2093>; Byron F. Egan, *Joint Venture Formation*, 44 TEX. J. BUS. LAW 129 (2012); James R. Bridges and Leslie E. Sherman, *Structuring Joint Ventures*, 4 INSIGHTS 17 (Oct. 1990); David Ernst and Stephen I. Glover, *Combining Legal and Business Practices to Create Successful Strategic Alliances*, 11 INSIGHTS 6 (Oct. 1997); Stephen I. Glover, *Joint Ventures and Opportunity Doctrine Problems*, 9 INSIGHTS 9 (Nov. 1995); Warren S. de Wied, *Structuring Strategic Equity Investments*, 1 No. 8 M&A LAW. 7 (Jan. 1998).

¹⁰⁹ *Pitts & Collard, L.L.P. v. Schechter*, No. 01-08-00969-CV, 2011 WL 6938515, at *11 (Tex. App.—Houston [1st Dist.] Dec. 29, 2011, no pet.).

¹¹⁰ In *Dernick Resources, Inc. v. Wilstein, et al.*, 312 S.W.3d 864, 877 (Tex. App.—Houston [1st Dist.] 2009, no pet.), which involved an oil and gas drilling and production arrangement pursuant to a contract that was called a “joint venture agreement,” the Court in an opinion by Justice Evelyn Keyes held that the joint venture agreement created a fiduciary relationship that imposed a fiduciary duty of full and fair disclosure on the managing venturer as it held title to the venture’s properties in its name and had a power of attorney to dispose of the properties, and explained:

Joint venturers for the development of a particular oil and gas lease have fiduciary duties to each other arising from the relationship of joint ownership of the mineral rights of the lease. [citation omitted] Likewise, if there is a joint venture between the operating owner of an interest in oil and gas well drilling operations and the non-operating interest owners, the operating owner owes a fiduciary duty to the non-operating interest owners. [citation omitted] In addition, “[a]n appointment of an attorney-in-fact creates an agency relationship,” and an agency creates a fiduciary relationship as a matter of law. [citation omitted] The scope of the fiduciary duties raised by a joint venture relationship, however, does not extend beyond the development of the particular lease and activities related to that development.

The dispute revolved around the manager’s sale of parts of its interest after giving oral notice to the other venturer, but not the written notice accompanied by full disclosure specified in the agreement. The opinion is lengthy and very fact specific, but the following lessons can be drawn from it: (i) calling a relationship a joint venture can result in a court categorizing the relationship as fiduciary, which in turn implicates fiduciary duties of candor and loyalty and could implicate the common law corporate opportunity doctrine (which is part of the fiduciary duty of loyalty), (ii) it is important to document the relationship intended (an LLC could be used as the joint venture entity and the LLC company agreement could define, or in Delaware eliminate, fiduciary duties), and (iii) written agreements should be understood and followed literally.

¹¹¹ See JOINT VENTURE TASK FORCE OF NEGOTIATED ACQUISITIONS COMMITTEE, MODEL JOINT VENTURE AGREEMENT WITH COMMENTARY (Am. Bar Ass’n., 2006).

venture will be driven by the venturers' tax situation, accounting goals, business objectives and financial needs, as well as the venturers' planned capital and other contributions to the venture, and antitrust and other regulatory considerations.¹¹² A key element in structuring any joint venture is the allocation among the parties of duties, including fiduciary duties.¹¹³ Irrespective of the structure chosen, however, certain elements are typically considered in connection with structuring every joint venture.

Because a joint venture is commonly thought of as a limited duration general partnership formed for a specific business activity, the owners of a joint venture are sometimes referred to as “partners” or “venturers,” and the joint venture as the “entity,” “partnership” or “venture,” in each case irrespective of the particular form of entity or other structure selected for the joint venture. Today the LLC is typically the entity of choice for the formation of a joint venture because, as discussed below, it offers structuring flexibility and limited owner liability for joint venture activities under both the TBOC, which now governs all LLCs formed under Texas law, and the Delaware Limited Liability Company Act (the “DLLCA”).¹¹⁴

1.6. Choice of Entity. To facilitate the entity choice analysis, included herein are (1) analyses of aspects of issues associated with the respective business entities; (2) a Federal Taxation of Entities Chart in Appendix A; (3) a Texas Margin Tax Chart in Appendix B; and (4) a Choice of Entity Decision Matrix in Appendix C.

CHAPTER 2. CORPORATIONS.

2.1. General. The primary advantages of operating a business as a corporation are generally considered to include:

- Limited liability of shareholders
- Centralization of management
- Flexibility in capital structure
- Status as a separate legal entity

The primary disadvantages of operating a business as a corporation are generally considered to be as follows:

- Expense of formation and maintenance
- Statutorily required formalities
- Tax treatment—double taxation for the C-corporation and restrictions on the S-corporation; state franchise taxes

¹¹² See Byron F. Egan, *Joint Venture Critical Issues: Formation, Governance, Competition and Exits*, UT Law CLE 10th Annual Mergers and Acquisitions Institute, Oct. 16, 2014, available at <http://www.jw.com/publications/article/2009>.

¹¹³ See Byron F. Egan, *How Recent Fiduciary Duty Cases Affect Advice to Directors and Officers of Delaware and Texas Corporations*, UTCLE 37th Annual Conference on Securities Regulation and Business Law, Feb. 13, 2015, available at <http://www.jw.com/publications/article/2033>.

¹¹⁴ Del. Code Ann. tit. 6 § 18-101 *et. seq.*

Prior to January 1, 2006, Texas business corporations were organized under the TBCA.¹¹⁵ Corporations formed after January 1, 2006 are organized under and governed by the TBOC. For entities formed before January 1, 2006, only the ones voluntarily opting into the TBOC, or converting to a Texas entity on or after January 1, 2006, were governed by the TBOC until January 1, 2010; from and after January 1, 2010, all Texas corporations are governed by the TBOC.¹¹⁶

The TBOC provides that the TBOC provisions applicable to corporations (TBOC Titles 1 and 2) may be officially and collectively known as “Texas Corporation Law.”¹¹⁷ However, because until 2010 some Texas for-profit corporations were governed by the TBCA and others by the TBOC, and because the substantive principles under both statutes are generally the same, the term “Tex. Corp. Stats.” is used herein to refer to the TBOC and the TBCA (as supplemented by the TMCLA) collectively, and the particular differences between the TBCA and the TBOC are referenced as appropriate.

2.2. Formation and Governing Documents. The formation of a corporation requires conformity with statutory formalities and the preparation of governing documents.

2.2.1. Charter.

(a) Primacy of Charter. In both Delaware and Texas a for-profit corporation is formed by filing with the applicable Secretary of State a charter document,¹¹⁸ which is the highest governing document of a corporation. In Delaware this takes the form of a certificate of incorporation, while in Texas this document is called a certificate of formation (hereinafter for both states, the “Charter”).¹¹⁹ In Delaware the Charter’s primacy comes from DGCL § 109, which provides that “[t]he bylaws may contain any provision, not inconsistent with law *or with the certificate of incorporation*, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers, or employees” (emphasis added).¹²⁰ Texas has similar statutory authority from TBOC § 21.057 which states: “The bylaws may contain provisions for the regulation and management of the affairs of the corporation that are consistent with law and *the corporation’s certificate of formation*” (emphasis added).¹²¹

(b) Adoption and Amendment of the Charter. Under both Delaware and Texas law, a Charter must be filed with the Secretary of State to bring a corporation into existence.¹²²

¹¹⁵ TBCA arts. 1.01 *et. seq.*

¹¹⁶ See *Sneed v. Webre*, 465 S.W.3d 169, 177 at note 4 (Tex. 2015); all foreign entities which initially register to do business in Texas after January 1, 2006 are subject to the TBOC, regardless when formed. TBOC § 402.001(a)(13).

¹¹⁷ TBOC § 1.008(b).

¹¹⁸ TBOC §§ 3.001-3.008; DGCL § 1.01.

¹¹⁹ *Id.*

¹²⁰ DGCL § 109.

¹²¹ TBOC § 21.057(b).

¹²² TBOC §§ 3.001-3.008; DGCL § 1.01.

(1) Delaware. Under the DGCL, different rules apply for the adoption of an amendment to the Charter depending on the circumstances the corporation is in at the time. Before the corporation has received payment for any stock, if no directors were named in the Charter, then the incorporators can amend the charter by a majority vote.¹²³ If directors were named, then they can amend the Charter by majority vote.¹²⁴ If payment was received for stock, then the following procedure must be observed. First, the Board must adopt a resolution setting forth the amendment proposed, declaring its advisability, and either calling a special meeting of the stockholders entitled to vote on the amendment or directing that the amendment proposed be considered at the next annual meeting of the stockholders (with all of the regular notice rules applying).¹²⁵ Then, if a majority of the outstanding stock entitled to vote on the amendment approve it, a certificate setting forth the amendment must be filed with the Delaware Secretary of State.¹²⁶ Alternatively, the amendment could be approved by written consent of the number of shareholders that would be necessary under the Charter to approve the action.¹²⁷

(2) Texas. Under the TBOC, the Board must first adopt a resolution stating a proposed amendment to the Charter. As under the DGCL, different rules apply under the TBOC for the adoption of an amendment to the Charter depending on the circumstances the corporation is in at the time. If no shares of stock have been issued the Board may adopt a proposed amendment to the Charter by resolution without shareholder approval.¹²⁸ If a corporation has outstanding and issued shares, however, the resolution passed by the directors must include a provision to submit the amendment to a shareholder vote and then the shareholders must approve the amendment.¹²⁹ The corporation must then hold a meeting to consider the proposed amendment obeying all the usual rules for notice to shareholders and the number of shareholders required for an approval of a fundamental action under either the Charter or the default rules.¹³⁰ Alternatively, the amendment could be approved by unanimous written consent of the shareholders or, if the Charter allows it, by written consent of the number of shareholders that

¹²³ DGCL § 241.

¹²⁴ *Id.*

¹²⁵ DGCL § 242.

¹²⁶ *Id.* DGCL § 242 further provides that: “The holders of the outstanding shares of a class shall be entitled to vote as a class upon a proposed amendment, whether or not entitled to vote thereon by the certificate of incorporation, if the amendment would increase or decrease the aggregate number of authorized shares of such class, increase or decrease the par value of the shares of such class, or alter or change the powers, preferences, or special rights of the shares of such class so as to affect them adversely. If any proposed amendment would alter or change the powers, preferences, or special rights of 1 or more series of any class so as to affect them adversely, but shall not so affect the entire class, then only the shares of the series so affected by the amendment shall be considered a separate class for the purposes of this paragraph. The number of authorized shares of any such class or classes of stock may be increased or decreased (but not below the number of shares thereof then outstanding) by the affirmative vote of the holders of a majority of the stock of the corporation entitled to vote irrespective of this subsection, if so provided in the original certificate of incorporation, in any amendment thereto which created such class or classes of stock or which was adopted prior to the issuance of any shares of such class or classes of stock, or in any amendment thereto which was authorized by a resolution or resolutions adopted by the affirmative vote of the holders of a majority of such class or classes of stock.” *Id.*

¹²⁷ DGCL § 228.

¹²⁸ TBOC § 21.053.

¹²⁹ TBOC § 21.054.

¹³⁰ TBOC § 21.055.

would be necessary under the Charter to approve the action.¹³¹ After the requisite approvals, the Charter is amended by filing a certificate of amendment with the Texas Secretary of State.¹³²

(c) Contents of Charter. Both Delaware and Texas require certain information to be included in the Charter.

(1) Delaware. In Delaware the Charter must contain the name of the corporation, the address of the corporation's registered office in Delaware; the nature of the business or purposes to be conducted or promoted; if the corporation has only one class of stock, the total number of shares of stock which the corporation shall have authority to issue and the par value of each of such shares, or a statement that all such shares are to be without par value or if the corporation is to be authorized to issue more than one class of stock, the Charter shall set forth the total number of shares of all classes of stock which the corporation shall have authority to issue and the number of shares of each class and shall specify each class the shares of which are to be without par value and each class the shares of which are to have par value and the par value of the shares of each such class; and the name and mailing address of the incorporator or incorporators.¹³³ Additionally, if the corporation desires to include such provisions it must include a statement of designation for all classes of shares and if the powers of the incorporator or incorporators are to terminate upon the filing of the Charter, the names and mailing addresses of the persons who are to serve as directors until the first annual meeting of stockholders or until their successors are elected and qualify.¹³⁴ DGCL § 102(b) provides for permissive inclusion of certain provisions in

¹³¹ TBOC §§ 6.201 and 6.202.

¹³² TBOC §§ 3.052-3.054.

¹³³ DGCL § 102(a).

¹³⁴ *Id.* The full text of DGCL § 102(a) is as follows:

(a) The certificate of incorporation shall set forth:

(1) The name of the corporation, which (i) shall contain 1 of the words "association," "company," "corporation," "club," "foundation," "fund," "incorporated," "institute," "society," "union," "syndicate," or "limited," (or abbreviations thereof, with or without punctuation), or words (or abbreviations thereof, with or without punctuation) of like import of foreign countries or jurisdictions (provided they are written in roman characters or letters); provided, however, that the Division of Corporations in the Department of State may waive such requirement (unless it determines that such name is, or might otherwise appear to be, that of a natural person) if such corporation executes, acknowledges and files with the Secretary of State in accordance with § 103 of this title a certificate stating that its total assets, as defined in subsection (i) of § 503 of this title, are not less than \$10,000,000, (ii) shall be such as to distinguish it upon the records in the office of the Division of Corporations in the Department of State from the names that are reserved on such records and from the names on such records of each other corporation, partnership, limited partnership, limited liability company or statutory trust organized or registered as a domestic or foreign corporation, partnership, limited partnership, limited liability company or statutory trust under the laws of this State, except with the written consent of the person who has reserved such name or such other foreign corporation or domestic or foreign partnership, limited partnership, limited liability company or statutory trust, executed, acknowledged and filed with the Secretary of State in accordance with § 103 of this title and (iii) shall not contain the word "bank," or any variation thereof, except for the name of a bank reporting to and under the supervision of the State Bank Commissioner of this State or a subsidiary of a bank or savings association (as those terms are defined in the Federal Deposit Insurance Act, as amended, at 12 U.S.C. § 1813), or a corporation regulated under the Bank Holding Company Act of 1956, as amended, 12

U.S.C. § 1841 et seq., or the Home Owners' Loan Act, as amended, 12 U.S.C. § 1461 et seq.; provided, however, that this section shall not be construed to prevent the use of the word "bank," or any variation thereof, in a context clearly not purporting to refer to a banking business or otherwise likely to mislead the public about the nature of the business of the corporation or to lead to a pattern and practice of abuse that might cause harm to the interests of the public or the State as determined by the Division of Corporations in the Department of State;

(2) The address (which shall include the street, number, city and county) of the corporation's registered office in this State, and the name of its registered agent at such address;

(3) The nature of the business or purposes to be conducted or promoted. It shall be sufficient to state, either alone or with other businesses or purposes, that the purpose of the corporation is to engage in any lawful act or activity for which corporations may be organized under the General Corporation Law of Delaware, and by such statement all lawful acts and activities shall be within the purposes of the corporation, except for express limitations, if any;

(4) If the corporation is to be authorized to issue only 1 class of stock, the total number of shares of stock which the corporation shall have authority to issue and the par value of each of such shares, or a statement that all such shares are to be without par value. If the corporation is to be authorized to issue more than 1 class of stock, the certificate of incorporation shall set forth the total number of shares of all classes of stock which the corporation shall have authority to issue and the number of shares of each class and shall specify each class the shares of which are to be without par value and each class the shares of which are to have par value and the par value of the shares of each such class. The certificate of incorporation shall also set forth a statement of the designations and the powers, preferences and rights, and the qualifications, limitations or restrictions thereof, which are permitted by § 151 of this title in respect of any class or classes of stock or any series of any class of stock of the corporation and the fixing of which by the certificate of incorporation is desired, and an express grant of such authority as it may then be desired to grant to the board of directors to fix by resolution or resolutions any thereof that may be desired but which shall not be fixed by the certificate of incorporation. The foregoing provisions of this paragraph shall not apply to nonstock corporations. In the case of nonstock corporations, the fact that they are not authorized to issue capital stock shall be stated in the certificate of incorporation. The conditions of membership, or other criteria for identifying members, of nonstock corporations shall likewise be stated in the certificate of incorporation or the bylaws. Nonstock corporations shall have members, but failure to have members shall not affect otherwise valid corporate acts or work a forfeiture or dissolution of the corporation. Nonstock corporations may provide for classes or groups of members having relative rights, powers and duties, and may make provision for the future creation of additional classes or groups of members having such relative rights, powers and duties as may from time to time be established, including rights, powers and duties senior to existing classes and groups of members. Except as otherwise provided in this chapter, nonstock corporations may also provide that any member or class or group of members shall have full, limited, or no voting rights or powers, including that any member or class or group of members shall have the right to vote on a specified transaction even if that member or class or group of members does not have the right to vote for the election of the members of the governing body of the corporation. Voting by members of a nonstock corporation may be on a per capita, number, financial interest, class, group, or any other basis set forth. The provisions referred to in the 3 preceding sentences may be set forth in the certificate of incorporation or the bylaws. If neither the certificate of incorporation nor the bylaws of a nonstock corporation state the conditions of membership, or other criteria for identifying members, the members of the corporation shall be deemed to be those entitled to vote for the election of the members of the governing body pursuant to the certificate of incorporation or bylaws of such corporation or otherwise until thereafter otherwise provided by the certificate of incorporation or the bylaws;

the Charter and includes any provision for the management of the business and for the conduct of the affairs of the corporation; any provision creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders, or any class of the stockholders; any provision that is required or permitted to be stated in the bylaws; preemptive rights provisions; provisions increasing the voting requirements of stockholders or directors for certain issues; a provision limiting the corporation's existence to a specified date; provisions imposing personal liability on stockholders for the debts of the corporation; or provisions eliminating or limiting the personal liability of a director.¹³⁵

(5) The name and mailing address of the incorporator or incorporators;

(6) If the powers of the incorporator or incorporators are to terminate upon the filing of the certificate of incorporation, the names and mailing addresses of the persons who are to serve as directors until the first annual meeting of stockholders or until their successors are elected and qualify.

¹³⁵

DGCL § 102(b) provides as follows:

(b) In addition to the matters required to be set forth in the certificate of incorporation by subsection (a) of this section, the certificate of incorporation may also contain any or all of the following matters:

(1) Any provision for the management of the business and for the conduct of the affairs of the corporation, and any provision creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders, or any class of the stockholders, or the governing body, members, or any class or group of members of a nonstock corporation; if such provisions are not contrary to the laws of this State. Any provision which is required or permitted by any section of this chapter to be stated in the bylaws may instead be stated in the certificate of incorporation;

(2) The following provisions, in haec verba, (i), for a corporation other than a nonstock corporation, viz:

“Whenever a compromise or arrangement is proposed between this corporation and its creditors or any class of them and/or between this corporation and its stockholders or any class of them, any court of equitable jurisdiction within the State of Delaware may, on the application in a summary way of this corporation or of any creditor or stockholder thereof or on the application of any receiver or receivers appointed for this corporation under § 291 of Title 8 of the Delaware Code or on the application of trustees in dissolution or of any receiver or receivers appointed for this corporation under § 279 of Title 8 of the Delaware Code order a meeting of the creditors or class of creditors, and/or of the stockholders or class of stockholders of this corporation, as the case may be, to be summoned in such manner as the said court directs. If a majority in number representing three fourths in value of the creditors or class of creditors, and/or of the stockholders or class of stockholders of this corporation, as the case may be, agree to any compromise or arrangement and to any reorganization of this corporation as consequence of such compromise or arrangement, the said compromise or arrangement and the said reorganization shall, if sanctioned by the court to which the said application has been made, be binding on all the creditors or class of creditors, and/or on all the stockholders or class of stockholders, of this corporation, as the case may be, and also on this corporation”; or

(3) Such provisions as may be desired granting to the holders of the stock of the corporation, or the holders of any class or series of a class thereof, the preemptive right to subscribe to any or all additional issues of stock of the corporation of any or all classes or series thereof, or to any securities of the corporation convertible into such stock. No stockholder shall have any preemptive right to subscribe to an additional issue of stock or to any security convertible into such stock unless, and except to the extent that, such right is

(2) Texas. In Texas the information that must be included in a corporation's Charter comes first from the general provisions of the TBOC which require inclusion of the name of the filing entity being formed;¹³⁶ the type of filing entity being formed; the purpose or purposes for which the filing entity is formed; the period of duration; the street address of the initial registered office of the filing entity and the name of the initial registered agent;¹³⁷ and the name and address

expressly granted to such stockholder in the certificate of incorporation. All such rights in existence on July 3, 1967, shall remain in existence unaffected by this paragraph unless and until changed or terminated by appropriate action which expressly provides for the change or termination;

(4) Provisions requiring for any corporate action, the vote of a larger portion of the stock or of any class or series thereof, or of any other securities having voting power, or a larger number of the directors, than is required by this chapter;

(5) A provision limiting the duration of the corporation's existence to a specified date; otherwise, the corporation shall have perpetual existence;

(6) A provision imposing personal liability for the debts of the corporation on its stockholders to a specified extent and upon specified conditions; otherwise, the stockholders of a corporation shall not be personally liable for the payment of the corporation's debts except as they may be liable by reason of their own conduct or acts;

(7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit. No such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective. All references in this paragraph to a director shall also be deemed to refer to such other person or persons, if any, who, pursuant to a provision of the certificate of incorporation in accordance with § 141(a) of this title, exercise or perform any of the powers or duties otherwise conferred or imposed upon the board of directors by this title.

¹³⁶ TBOC § 5.053(a) prohibits a filing entity and a foreign filing entity from having an identical or deceptively similar name as another filing entity or foreign filing entity and prohibits the secretary of state from reserving or registering a name that is the same as or deceptively similar to the name of an existing entity name or a name that is already reserved or registered. Under TBOC § 5.053(b), an affected entity may consent in writing to the use of the name by providing to the Secretary of State a notarized written statement of the entity's or person's consent to such use, reservation, or registration.

¹³⁷ Under TBOC § 5.201(b), a registered agent in Texas must be a resident individual or business registered or authorized to do business in the state. A registered agent must consent to serve as such before being designated or appointed in a filing with the Secretary of State of Texas after January 1, 2010. TBOC § 5.201(b), as amended in the 2009 Legislative Session by 2009 H.B. 1787 effective January 1, 2010, requires that a registered agent for service of process consent to serve as such in a written or electronic form to be developed by the Secretary of State of Texas. This consent requirement is applicable to any domestic or foreign entity, including any corporation, partnership, LLC or financial institution, that designates a registered agent in a filing with the Secretary of State. It applies to both for-profit and non-profit entities, and to both individual and corporate agents. It does not require an entity formed prior to January 1, 2010 to obtain a consent from an existing agent unless there is a transfer of a majority in interest of the entity, but it does require that a consent be obtained by an existing entity whenever it makes a filing with the Secretary of State that changes the agent.

The consent is not to be filed with the Secretary of State. It should be maintained among the entity's organization documents and be available for review by attorneys and others seeking evidence that the entity has complied with applicable laws. A minute book is a good place to keep the consent.

of each organizer.¹³⁸ Additionally, a Charter must include the aggregate number of shares the corporation is authorized to issue; the par value of each class of shares or a statement that each share is without par value; and the number of directors constituting the initial board of directors and the names and addresses of the persons constituting the initial board of directors.¹³⁹ Finally, a Charter may include provisions: dividing the corporation's authorized shares into one or more classes and further dividing one or more classes into one or more series and if such a provision is included, the Charter must designate each class and series of authorized shares to distinguish that class and series from any other class or series;¹⁴⁰ providing for certain special characteristics of shares;¹⁴¹ allowing the board of directors to establish series of unissued shares of any class by

TBOC § 5.206 specifies that the sole duties of a registered agent are to (i) forward or notify the entity of any process, notice, or demand served on the agent and (ii) provide the notices required or permitted by law to the entity. A person named a registered agent without the person's consent is not required to perform these duties.

TBOC § 5.2011 provides that the appointment of a person as registered agent is an affirmation by the entity that a person has consented to serve as the registered agent. The maintenance of a person as registered agent after a transfer of a majority interest in the ownership or membership interests of the entity is an affirmation by the governing authority of the entity that the person consents to continue as the agent. TBOC § 5.207 extends TBOC §§ 4.007 and 4.008, which prescribe civil remedies and criminal penalties for filing a false statement with the Secretary of State, to a registered agent filing with the Secretary of State that names the registered agent without the person's consent.

TBOC § 5.208 shields a person appointed as the registered agent from liability by reason of the person's appointment for the debts, liabilities, and obligations of the entity. Further, a person who has not consented to appointment as registered agent is shielded from a judgment, decree or order of a court, agency or other tribunal for a debt, obligation or liability of the entity, whether in contract or tort. This liability protection extends to a claim of a person who reasonably relies on the unauthorized designation by reason of the person's failure or refusal to perform the duties of registered agent.

Under TBOC § 5.204, the resignation of a registered agent terminates both the appointment of the agent and the designation of the registered office. TBOC § 5.205 provides that a statement of rejection that may be filed by a person designated or appointed as a registered agent without the person's consent. Filing this statement terminates the appointment and the designation of the registered office, and triggers a notice from the Secretary of State to the entity of the necessity of designating or appointing a new registered agent or registered office.

¹³⁸ TBOC § 3.005.

¹³⁹ TBOC § 3.007. If the shares a corporation is authorized to issue consist of more than one class of shares the certificate of formation must state:

“the designation of the class; the aggregate number of shares in the class; the par value of each share or a statement that each share is without par value; the preferences, limitations, and relative rights of the shares; and if the shares in a class the corporation is authorized to issue consist of more than one series, the following with respect to each series: the designation of the series; the aggregate number of shares in the series; any preferences, limitations, and relative rights of the shares to the extent provided in the certificate of formation; and any authority vested in the board of directors to establish the series and set and determine the preferences, limitations, and relative rights of the series.”

¹⁴⁰ TBOC § 21.152. One or more series of these class of shares must have unlimited voting rights and one or more classes or series of shares, which may be the same class or series of shares as those with voting rights, that together are entitled to receive the net assets of the corporation on winding up and termination. *Id.* TBOC § 21.153 further provides that “If more than one class or series of shares is authorized under Section 21.152(d), the certificate of formation must state the designations, preferences, limitations, and relative rights, including voting rights, of each class or series.”

¹⁴¹ TBOC § 21.154.

setting and determining the designations, preferences, limitations, and relative rights of the shares;¹⁴² providing for preemptive rights;¹⁴³ share transfer restrictions;¹⁴⁴ that adjust the quorum and voting requirements;¹⁴⁵ allowing for cumulative voting;¹⁴⁶ proscribing qualifications for board member eligibility;¹⁴⁷ governing the number, quorum requirements, and voting requirements for directors;¹⁴⁸ allowing for classified boards;¹⁴⁹ and authorizing committees on the board of directors.¹⁵⁰

(d) Issuance of Stock. Equity can be raised at the base level by the issuance of common stock and at levels ranking above the common stock by the issuance of preferred stocks.¹⁵¹ Equity can be leveraged through many types of borrowings and financing devices, including stock options, warrants, and other forms of securities. In addition, convertible debt interests may be utilized. The different levels of a capital structure may include a differentiation in the voting rights assigned to equity holders, which may even be distributed differently among classes of common stock or even denied as to specified classes of common stock.

A Texas corporation may issue shares for such consideration, not less than the par value thereof, approved by its board of directors.¹⁵² Shares may be issued for cash, promissory notes, services performed or a contract for services to be performed, securities of the corporation or another entity, any tangible or intangible benefit to the corporation, or any property of any kind or nature.¹⁵³ When the consideration is a note or future services, the corporation may issue the shares into escrow, or may provide that the shares may not be transferred or entitled to receive distributions, until the note is paid or the services performed.¹⁵⁴

(e) Reverse Splits. By an amendment to its Charter, a corporation may effect a reverse split of its stock to reduce the number of outstanding shares. In a reverse split, each share becomes a fraction of a whole share, no fractional shares are issued, and any shareholder who would receive a fractional share is instead paid in cash the fair value of the fractional share.¹⁵⁵ There are no shareholder appraisal rights for the determination of the fair value of a fractional share, which leaves it to the Board in the exercise of its powers and fiduciary duties to fix the fair value and to unhappy shareholders to go to court.

¹⁴² TBOC § 21.155.

¹⁴³ TBOC § 21.203.

¹⁴⁴ TBOC § 21.210.

¹⁴⁵ TBOC §§ 21.358, 21.364, 21.365, 21.366, 21.457, 21.458.

¹⁴⁶ TBOC § 21.359

¹⁴⁷ TBOC § 21.402

¹⁴⁸ TBOC §§ 21.403, 21.406, 21.413, 21.415.

¹⁴⁹ TBOC § 21.408.

¹⁵⁰ TBOC § 21.416 The foregoing list of permissive provisions is illustrative and not comprehensive.

¹⁵¹ *See id.*; TBOC §§ 21.152-21.157.

¹⁵² TBOC §§ 21.175 and 21.161.

¹⁵³ TBOC § 21.159.

¹⁵⁴ TBOC § 21.157(c), as added in the 2009 Legislative Session by 2009 S.B. 1442 § 30.

¹⁵⁵ TBOC §§ 3.051 and 21.163; DGCL §§ 155 and 242.

In *Reis v. Hazelett Strip-Casting Corporation*,¹⁵⁶ the controlling 70% stockholder of the corporation cashed out the minority shares held by the estate of his deceased brother and its multiple beneficiaries via a reverse stock split in an effort to keep the family business closely held. Although Vice Chancellor Laster commented that “[f]inal stage transactions for stockholders provide another situation where enhanced scrutiny applies,” he applied the entire fairness standard because of the lack of process, and commented:

A reverse split in which stockholders receive cash in lieu of fractional interests is an end stage transaction for those stockholders being cashed out of the enterprise. A disinterested and independent board’s decision to pay cash in lieu of fractional share therefore should be subject to enhanced scrutiny. ***

When a controlling stockholder uses a reverse split to freeze out minority stockholders without any procedural protections, the transaction will be reviewed for entire fairness with the burden of proof on the defendant fiduciaries. *** A reverse split under those circumstances is the “functional equivalent” of a cash out merger. *** If the controlling stockholder permits the board to form a duly empowered and properly functioning special committee or if the transaction is conditioned on a correctly formulated majority-of-the-minority vote, then the burden could shift to the plaintiff to prove that the transaction was unfair. *** If the controlling stockholder permits the use of both protective devices, then the transaction could avoid entire fairness review.

In *Hazelett* the Board consisted of employees who maintained their independent and disinterested status, but the Vice Chancellor did not credit their testimony and found that “[t]he natural pulls of the directors’ affiliations were too strong, and at no point did any of them actually act independently.” The Vice Chancellor found that the defendants did not meet their burden of proving entire fairness and awarded damages based on his determination of the fair value of the fractional shares.

2.2.2. Bylaws.

(a) Power to Adopt or Amend Bylaws. The Texas Corporate Statutes and the DGCL each provide that the business and affairs of a corporation are to be managed under the direction of its Board.¹⁵⁷ Each also provides that both the Board and the shareholders have the power to adopt, amend or repeal the corporation’s bylaws.¹⁵⁸

¹⁵⁶ 28 A.3d 442, 449 (Del. Ch. 2011).

¹⁵⁷ TBOC § 21.401; TBCA art. 2.31; DGCL § 141(a). *See supra* notes 258 and 259 and related text.

¹⁵⁸ DGCL § 109 provides as follows:

§ 109. Bylaws. (a) The original or other bylaws of a corporation may be adopted, amended or repealed by the incorporators, by the initial directors if they were named in the certificate of incorporation, or, before a corporation has received any payment for any of its stock, by its board of directors. After a corporation has received any payment for any of its stock, the power to adopt, amend or repeal bylaws shall be in the stockholders entitled to vote, or, in the case of a nonstock corporation, in its members entitled to vote; provided, however, any corporation may, in its certificate of incorporation, confer the power to adopt, amend or repeal

In Texas, after the Secretary of State officially acknowledges the filing of the corporation's certificate of formation,¹⁵⁹ there should be an organizational meeting of the initial board of directors named in the corporation's governing document (at the call of a majority of the directors) for the purposes of adopting bylaws, electing officers and transacting such other business as may come before the meeting.¹⁶⁰ The bylaws may contain any provisions for the regulation and management of the affairs of the corporation not inconsistent with law or the corporation's certificate of formation.¹⁶¹ Although the initial bylaws of a corporation are ordinarily in writing and adopted by the directors at the organization meeting of the board, the shareholders may amend, repeal or adopt the bylaws, unless the corporation's governing document or a bylaw adopted by the shareholders provides otherwise.¹⁶² In the absence of a contrary provision in the corporation's governing document, the TBCA or the TBOC, bylaws may be adopted or amended orally or by acts evidenced by a uniform course of proceeding or usage and acquiescence.¹⁶³

In *CA, Inc. v. AFSCME Employees Pension Plan*, the Delaware Supreme Court addressed the dual power of the Board and the stockholders to amend bylaws in answering two questions that had been certified to it by the SEC.¹⁶⁴ The questions of law certified by the SEC to the

bylaws upon the directors or, in the case of a nonstock corporation, upon its governing body by whatever name designated. The fact that such power has been so conferred upon the directors or governing body, as the case may be, shall not divest the stockholders or members of the power, nor limit their power to adopt, amend or repeal bylaws.

(b) The bylaws may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees. (8 Del. C. 1953, § 109; 56 Del. Laws, c. 50; 59 Del. Laws, c. 437, § 1).

TBOC §§ 21.057 and 21.058 provide as follows:

Section 21.057. Bylaws. (a) The board of directors of a corporation shall adopt initial bylaws.

(b) The bylaws may contain provisions for the regulation and management of the affairs of the corporation that are consistent with law and the corporation's certificate of formation.

(c) A corporation's board of directors may amend or repeal bylaws or adopt new bylaws unless:

(1) the corporation's certificate of formation or this code wholly or partly reserves the power exclusively to the corporation's shareholders; or

(2) in amending, repealing, or adopting a bylaw, the shareholders expressly provide that the board of directors may not amend, repeal, or readopt that bylaw.

Section 21.058. Dual Authority. Unless the certificate of formation or a bylaw adopted by the shareholders provides otherwise as to all or a part of a corporation's bylaws, a corporation's shareholders may amend, repeal, or adopt the corporation's bylaws regardless of whether the bylaws may also be amended, repealed, or adopted by the corporation's board of directors.

¹⁵⁹ TBOC § 4.002. Under pre-TBOC law, the Secretary of State would issue a Certificate of Incorporation once a corporation properly filed its Articles of Incorporation.

¹⁶⁰ TBCA art. 3.06; TBOC § 21.059.

¹⁶¹ TBCA art. 2.33A; TBOC § 21.057.

¹⁶² TBCA art. 2.23; TBOC § 21.058.

¹⁶³ *Keating v. K-C-K Corp.*, 383 S.W.2d 69 (Tex. Civ. App.—Houston [1st Dist.] 1964, no writ).

¹⁶⁴ 953 A.2d 227, 229 (Del. 2008).

Delaware Supreme Court were: (i) whether the proposed bylaw is a proper subject for action by stockholders as a matter of Delaware law and (ii) whether the proposed bylaw, if adopted, would cause the corporation to violate any Delaware law to which it is subject. The Court answered both questions in the affirmative – the proposed bylaw (1) was a proper subject for action by stockholders, but (2) would cause the corporation to violate Delaware law. The Court explained that the DGCL empowers both directors (so long as the certificate of incorporation so provides) and stockholders of a Delaware corporation with the ability to adopt, amend or repeal the corporation’s bylaws. Because the “stockholders of a corporation subject to DGCL may not directly manage the business and affairs of the corporation, at least without specific authorization in either the statute or the certificate of incorporation . . . the shareholders’ statutory power to adopt, amend or repeal bylaws is not coextensive with the board’s concurrent power and is limited by the board’s management prerogatives under Section 141(a).”¹⁶⁵ While it declined to “articulate with doctrinal exactitude a bright line” that would divide those bylaws that stockholders may permissibly adopt from those that would go too far in infringing upon the Board’s right to manage the corporation, the Court commented:

It is well-established Delaware law that a proper function of bylaws is not to mandate how the board should decide specific substantive business decisions, but rather, to define the process and procedures by which those decisions are made.

* * *

Examples of the procedural, process-oriented nature of bylaws are found in both the DGCL and the case law. For example, 8 *Del. C.* § 141(b) authorizes bylaws that fix the number of directors on the board, the number of directors required for a quorum (with certain limitations), and the vote requirements for board action. 8 *Del. C.* § 141(f) authorizes bylaws that preclude board action without a meeting. And, almost three decades ago this Court upheld a shareholder-enacted bylaw requiring unanimous board attendance and board approval for any board action, and unanimous ratification of any committee action. Such purely procedural bylaws do not improperly encroach upon the board’s managerial authority under Section 141(a).¹⁶⁶

The Court held that the proposed bylaw concerned the process for electing directors, which is a subject in which shareholders of Delaware corporations have a proper interest. Therefore, the proposed bylaw was a proper subject for stockholder action.

The Court, however, also found that the proposed bylaw could require the Board to reimburse dissident stockholders in circumstances where a proper application of fiduciary principles would preclude the Board from doing so (such as when a proxy contest was undertaken for “personal or petty concerns, or to promote interests that do not further, or are adverse to, those of the corporation”). Accordingly, the Court held that the proposed bylaw, as written, would violate Delaware law if enacted by stockholders.

¹⁶⁵ *Id.* at 232.

¹⁶⁶ *Id.* at 234-35.

(b) Effect of Bylaw Amendments on Director Terms and Removal of Directors. In *Crown EMAK Partners, LLC v. Kurz*,¹⁶⁷ the Delaware Supreme Court held bylaw amendments reducing the size of a Board to a number less than the number of sitting directors between annual meetings without first removing directors was not permitted by the DGCL and addressed what is, and what is not, impermissible vote-buying under Delaware law. The Supreme Court concluded that (i) stockholder adopted bylaw amendments may not shrink the size of the Board of a Delaware corporation below the number of sitting directors, (ii) the votes of a swing block of shares survived a “vote buying” challenge but were invalid because their transfer to an insurgent stockholder violated the transfer provisions of a restricted stock agreement pursuant to which they were issued and held, and (iii) the Court of Chancery’s expansive interpretation of the definition of “stockholders of record” to include certain institutional nominees was “*obiter dictum*” and “without precedential effect.”

In *Airgas, Inc. v. Air Products and Chemicals, Inc.*,¹⁶⁸ the Delaware Supreme Court invalidated a stockholder-proposed bylaw accelerating Airgas’s annual meeting by approximately eight months, which was adopted in the context of Air Products’ takeover battle with Airgas and would have given Air Products, whose nominees had been elected to the open directorships at Airgas’s 2010 annual meeting, the opportunity to elect additional directors to Airgas’s classified board just four months later (and, conceivably, to obtain control of a majority of Airgas’s board without waiting for a full two-year meeting cycle to run). Reversing a Chancery Court decision upholding the bylaw as not inconsistent with the classified board provision in Airgas’s charter, which provided that directors’ terms would expire at “the annual meeting of stockholders held in the third year following the year of their election,” the Supreme Court (like the Chancery Court) found the language of Airgas’s charter defining the duration of the directors’ terms to be ambiguous. The Supreme Court looked to extrinsic evidence to construe that provision and concluded that the language “has been understood to mean that the Airgas directors serve three year terms.” Accordingly, the Supreme Court held that the bylaw was invalid because it “prematurely terminate[d]” the three-year terms of Airgas’s directors provided by statute and Airgas’s charter. While the Supreme Court noted that neither DGCL § 141(d) nor Airgas’s charter “requires that the three year terms be measured with mathematical precision,” the Supreme Court concluded that the four-month period that would have resulted from the annual meeting bylaw did not “qualify under any construction of ‘annual’” within the meaning of DGCL § 141(d) or Airgas’s charter. The consequence of the bylaw, according to the Supreme Court, was to “so extremely truncate the directors’ term” as to frustrate the purpose behind Airgas’s classified board provision—i.e., to prevent the removal of directors without cause. Thus, the annual meeting bylaw was invalid “not only because it impermissibly shorten[ed] the directors’ three year staggered terms, but also because it amounted to a *de facto* removal without cause” without the super-majority vote required by Airgas’s charter.¹⁶⁹

¹⁶⁷ 992 A.2d 377, 378 (Del. 2010), affirming in part and reversing in part the Court of Chancery’s holding in *Kurz v. Holbrook*, 989 A.2d 140 (Del. Ch. 2010).

¹⁶⁸ 8 A.3d 1182, 1185 (Del. 2010).

¹⁶⁹ In *Goggin v. Vermillion, Inc.*, C.A. No. 6465-VCN, 2011 Del. Ch. LEXIS 80, at *8 (Del. Ch. June 3, 2011), an annual meeting of shareholders that would be held only six months after the prior year’s annual meeting was not enjoined in the absence of evidence that the scheduling of the meeting was intended to thwart the shareholder franchise.

(c) Forum Selection Provisions. Forum selection provisions in both corporate charters and bylaws are uncommon when compared to their ubiquity in business contracts. Bylaw forum selection provisions have been around since 1991,¹⁷⁰ but before 2010 only 16 companies had adopted forum selection provisions in a charter or bylaw provision.¹⁷¹ One of these 16 companies is Oracle Corporation whose directors adopted a bylaw in 2006¹⁷² that provides that “[t]he sole and exclusive forum for any actual or purported derivative action brought on behalf of the Corporation shall be the Court of Chancery in the State of Delaware.”¹⁷³

A passing comment by Vice Chancellor Laster in *In re Revlon, Inc. Shareholders Litigation*¹⁷⁴ seems to have had an impact in the expansion in the number of companies including forum selection provisions in their bylaws.¹⁷⁵ The *Revlon* case arose in the context of two groups of plaintiffs’ counsel jockeying for control of derivative litigation. The Vice Chancellor was unhappy with the original lead counsel’s conduct of the litigation (or lack thereof) and what he viewed as somewhat of a sham settlement. In the course of his over twenty page opinion on why the conduct of the litigation by original counsel was inadequate, the Vice Chancellor discussed the volume litigation strategy pursued by traditional plaintiffs’ firms in shareholder litigation and its questionable value to the class members and the companies.¹⁷⁶ During this discussion he addressed the policy considerations behind limiting frequent filers and noted that this might lead to more suits being filed in other jurisdictions if Delaware became too harsh on frequent filers and replaced them as lead counsel too frequently.¹⁷⁷ Addressing this concern the Vice Chancellor commented that “if boards of directors and stockholders believe that a particular

¹⁷⁰ See Joseph A. Grundfest & Kristen A. Savelle, *The Brouhaha Over Intra-Corporate Forum Selection Provisions: A Legal, Economic, and Political Analysis*, 68 BUS. LAW. 325 (Feb. 2013); Joseph A. Grundfest, *The History and Evolution of Intra-Corporate Forum Selection Clauses: An Empirical Analysis*, 37 DEL. J. CORP. L. 333 (2012).

¹⁷¹ Steven M. Davidoff, *A Litigation Plan that Would Favor Delaware*, NEW YORK TIMES DEAL BOOK, <http://tinyurl.com/m3z56z4> (Oct. 26, 2010).

¹⁷² Stanford professor Joseph Grundfest, a proponent of forum selection bylaws, was on Oracle’s board when it adopted this bylaw provision. See Steven M. Davidoff, *A Litigation Plan that Would Favor Delaware*, NEW YORK TIMES DEAL BOOK, <http://tinyurl.com/m3z56z4> (Oct. 26, 2010).

¹⁷³ *Galaviz v. Berg*, 10-cv-3392, slip op. at 3 (N.D. Cal. Jan. 3, 2011). Although the Oracle forum selection bylaw only applied to derivative actions, another “sample forum selection provision states that the Court of Chancery at the State of Delaware shall be the sole and exclusive forum for (1) any derivative action or proceeding brought on behalf of the corporation; (2) any action asserting a claim for breach of fiduciary duty owed by any director, officer or other employee of the corporation to the corporation or the corporation’s stockholders; (3) any action asserting a claim arising pursuant to any provision of the DGCL; or (4) any action asserting a claim governed by the internal affairs doctrine. Any person or entity purchasing or otherwise acquiring an interest in shares of capital stock of the corporation shall be deemed to have notice of and consented to the provisions of this article. That sample provision is a mandatory provision, meaning that it requires all litigation to be in Delaware. An alternative form of the by-law is permissive, in that it permits the corporation to consent in writing to the selection of an alternative forum. It give the board additional flexibility in case they like the jurisdiction in which the litigation has been brought.” *Towards State of the Art: Scrubbing Your Bylaws, Governance Guidelines & Committee Charters* (The Corporate Counsel.net January 12, 2011).

¹⁷⁴ 990 A.2d 940, 959 (Del. Ch. 2010).

¹⁷⁵ Steven M. Davidoff, *A Litigation Plan that Would Favor Delaware*, NEW YORK TIMES DEAL BOOK, <http://tinyurl.com/m3z56z4> (Oct. 26, 2010).

¹⁷⁶ 990 A.2d at 959.

¹⁷⁷ *Id.* at 960.

forum would provide an efficient and value-promoting locus for dispute resolution, the corporations are free to respond with charter provisions selecting an exclusive forum for intra-entity disputes.”¹⁷⁸

The first test for the validity of bylaw forum selection provisions involved the bylaw of Oracle quoted below. In *Galaviz v. Berg*,¹⁷⁹ the U.S. District Court for the Northern District of California denied motions to dismiss a derivative action for improper venue, finding the forum selection clause in the corporate bylaws of a Delaware corporation to be unenforceable. The plaintiffs in *Galaviz* brought a claim in the U.S. Court for the Northern District of California against the directors of Oracle alleging that each director was individually liable for breach of fiduciary duty and abuse of control in connection with certain actions allegedly taken by Oracle from 1998 to 2006.¹⁸⁰

In 2006, prior to the initiation of the *Galaviz* litigation, Oracle’s Board amended Oracle’s bylaws to include a forum selection provision which provided that “[t]he sole and exclusive forum for any actual or purported derivative action brought on behalf of the Corporation shall be the Court of Chancery in the State of Delaware.”¹⁸¹ The defendants contended that Oracle’s bylaws should be treated like any other contract and cited to cases in other contexts that described bylaws as representing a contract between a corporation and its shareholders.¹⁸² Accordingly, the defendants moved to dismiss the claims of the plaintiffs on the basis of improper venue, asserting that the forum selection clause in Oracle’s bylaws is binding upon the plaintiffs and that the proper venue for the claims is the Delaware Chancery Court.

In analyzing whether to grant the motion to dismiss, the Court distinguished between corporate bylaws and contracts, rejecting Oracle’s contention that the validity of a forum selection clause in corporate bylaws should be analyzed in the same manner as a forum selection clause in a contract.¹⁸³ The Court noted that Oracle sought to rely on principles of corporate law with respect to how its bylaws could be amended.¹⁸⁴ The Court believed this distinguished this case from federal contract law on forum selection clauses holding that “under contract law, a party’s consent to a written agreement may serve as consent to all the terms therein, whether or not all of them were specifically negotiated or even read, but it does not follow that a contracting party may thereafter unilaterally add or modify contractual provisions.”¹⁸⁵ As a result the Court held that the contract analysis did not control.¹⁸⁶ In so holding, the Court focused specifically on the fact that Oracle’s directors could unilaterally amend the corporation’s bylaws, the defendant’s in the action were the ones who amended the bylaw after the majority of the

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Id.

¹⁷⁹

10-cv-3392, slip op. (N.D. Cal. Jan. 3, 2011).

¹⁸⁰

Id. at 2.

¹⁸¹

Id. at 3.

¹⁸²

Id. at 5.

¹⁸³

The district court acknowledged that if federal contract law principles were controlling, “there would be little basis to decline to enforce” the forum selection clause in Oracle’s bylaws. *Id.* at 5. See *Argueta v. Banco Mexicano, S.A.*, 87 F.3d 320, 321 (9th Cir. 1996).

¹⁸⁴

Galaviz v. Berg, 10-cv-3392 at 6.

¹⁸⁵

Id.

¹⁸⁶

Id.

purported wrongdoing had occurred, and that the amendment had occurred without the consent of the existing shareholders.¹⁸⁷ Consequently, the District Court denied Oracle's motion to dismiss, finding that Oracle had otherwise failed to demonstrate the effectiveness of its forum selection bylaw under federal law such that it restricted the plaintiffs from pursuing their claims in the District Court.¹⁸⁸

As mentioned previously, the District Court noted that the *Galaviz* plaintiffs purchased shares in Oracle prior to the amendment to Oracle's bylaws adding the forum selection provision, that a majority of the alleged wrongdoing had occurred prior to the bylaw amendment, and that the same directors named as defendants had adopted the forum selection bylaw. If Oracle's bylaws had included a forum selection clause prior to any alleged wrongdoing or the purchase of shares in Oracle by the plaintiffs, the Court may have come to a different conclusion. Further, the Court suggested that if a majority of Oracle's stockholders had adopted the forum selection clause as a charter amendment, the case for treating the venue provision like those in commercial contracts would be much stronger even if the plaintiffs themselves had not voted for the amendment.¹⁸⁹ In this sense the *Galaviz* decision may be confined to its facts.

In a consolidated opinion in *Boilermakers Local 154 Retirement Fund v. Chevron Corporation, et al.*¹⁹⁰ and *ICLUB Investment Partnership v. FedEx Corporation, et al.*,¹⁹¹ Chancellor Strine held that the unilateral adoption by a Board of a forum selection bylaw that "designates a forum as the exclusive venue for certain stockholder suits against the corporation, either as an actual or nominal defendant, and its directors and employees" is both statutorily valid under the DGCL and contractually valid.¹⁹² In an effort to "address what they perceive to be the inefficient costs of defending against the same claim in multiple courts at one time," the Boards of Chevron Corporation and FedEx Corporation each unilaterally adopted without stockholder approval forum selection bylaw provisions. As initially adopted by each corporation, the forum selection bylaw provided that:

Unless the Corporation consents in writing to the selection of an alternative forum, the Court of Chancery of the State of Delaware shall be the sole and exclusive forum for (i) any derivative action or proceeding brought on behalf of the Corporation, (ii) any action asserting a claim of breach of a fiduciary duty owed by any director, officer or other employee of the Corporation to the Corporation or the Corporation's stockholders, (iii) any action asserting a claim arising pursuant to any provision of the Delaware General Corporation Law, or (iv) any action asserting a claim governed by the internal affairs doctrine. Any person or entity purchasing or otherwise acquiring any interest in shares of capital

¹⁸⁷ *Id.*

¹⁸⁸ *Id.* at 7.

¹⁸⁹ *Id.*

¹⁹⁰ 73 A.3d 934, 937 (Del. Ch. 2013).

¹⁹¹ *Id.* at 945.

¹⁹² The consolidated opinion only addresses the purely legal issues of whether forum selection bylaws are statutorily and contractually valid; the Chancellor did not address the plaintiffs' other counts involving "fiduciary duty claims and arguments about the ways in which the forum selection clauses could be inequitably adopted or applied in particular situations." *Id.* at 945.

stock of the Corporation shall be deemed to have notice of and consented to the provisions of this [bylaw].

These forum selection clauses were drafted to cover only four types of lawsuits, all of which related to claims brought by stockholders as stockholders:¹⁹³ (1) derivative suits relating to “whether a derivative plaintiff is qualified to sue on behalf of the corporation and whether that derivative plaintiff has or is excused from making demand on the board is a matter of corporate governance”; (2) fiduciary duty suits regarding the “relationships between directors, officers, the corporation, and its stockholders”; (3) DGCL suits regarding how, under the DGCL, the corporation is governed; and (4) internal affairs¹⁹⁴ suits regarding those “matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders.”

The plaintiffs complaints were “nearly identical” and alleged that forum selection bylaws were (i) “statutorily invalid because they go beyond the board’s authority under” the DGCL and (ii) contractually invalid “because they were unilaterally adopted by the... boards using their power to make bylaws” without approval by the stockholders whose rights were allegedly being diminished by such bylaw. Chancellor Strine held that the forum selection bylaws in question were statutorily valid because (i) the Boards of both companies were “empowered in their certificates of incorporation to adopt bylaws under DGCL § 109(a), which provides that any “corporation may, in its certificate of incorporation, confer the power to adopt, amend or repeal bylaws upon the directors...” and (ii) the forum selection bylaws addressed a proper subject matter under DGCL § 109(b), which provides that a bylaw “may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors’, officers or employees.” Chancellor Strine noted that “bylaws of Delaware corporations have a ‘procedural, process-oriented nature’” and that DGCL § 109(b) “has long been understood to allow the corporation to set ‘self-imposed rules and regulations [that are] deemed expedient for its convenient functioning.’” In the Chancellor’s view, forum selection bylaws fit squarely within this construct and are therefore a proper subject matter under DGCL § 109(b) because such bylaws “are process-oriented” as they “regulate *where* stockholders may file suit, not *whether* the stockholder may file suit or the kind of remedy that the stockholder may obtain on behalf of herself or the corporation.”

Addressing the plaintiffs’ argument that forum selection bylaws are not contractually valid because the affected stockholders did not vote in advance to approve such bylaws, Chancellor Strine noted that in each of the *Chevron* and *FedEx* cases, the stockholders in question knew in advance of acquiring stock that the corporation’s certificate of incorporation

¹⁹³ As opposed to a “tort claim against the company based on a personal injury” a stockholder may suffer that “occurred on the company’s premises or a contract claim based on a contractual contract” with the company, each of which would “not deal with the rights and powers of the plaintiff-stockholder *as a stockholder*.” *Id.* at 952.

¹⁹⁴ The “‘internal affairs doctrine is a conflict of laws principle which recognizes that only one State should have the authority to regulate a corporation’s internal affairs – matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders – because otherwise a corporation could be faced with conflicting demands.’” *Id.* at 938-39. *See supra* notes 264-269 and related text.

conferred on the Board the power to adopt bylaws unilaterally. Each group of stockholders, therefore, assented to be “bound by bylaws that are valid under the DGCL” that are unilaterally adopted by the Board, as such unilateral board rights are “an essential part of the contract agreed to when an investor buys stock in a Delaware corporation.”¹⁹⁵ In light of a Board’s power to unilaterally adopt bylaws, the Court described bylaws in general as “part of an inherently flexible contract between the stockholders and the corporation,” and noted that stockholders also “have powerful rights they can use to protect themselves if they do not want board-adopted forum selection bylaws to be part of the contract between themselves and the corporation,” such as repealing Board-adopted bylaws or having the annual opportunity to elect directors.

The Court emphasized, however, that stockholder-plaintiffs retain the ability to challenge the enforcement of such a bylaw in a particular case, either under the reasonableness standard adopted by the U.S. Supreme Court in *The Bremen v. Zapata Off-Shore Co.*,¹⁹⁶ or under fiduciary duty principles. The Court also left open the possibility that Board actions in adopting such bylaws could be subject to fiduciary duty challenges. Further, stockholders retain the unilateral right to repeal forum selection bylaws and proxy advisory firms generally recommend voting against them.¹⁹⁷

Forum selection provisions in corporate charters (like the bylaw forum selection provisions discussed above) were held to be presumptively valid in *Edgen Grp. Inc. v. Genoud*.¹⁹⁸ Although Edgen’s certificate of incorporation included a provision that provided that any claim of breach of fiduciary duty by an Edgen stockholder must be filed in Delaware, a class action suit challenging a recently announced merger of Edgen with an unrelated third party was filed in Louisiana state court. In response, Edgen filed suit against the stockholder in Delaware, asking the Court of Chancery to enjoin him from proceeding in Louisiana. Although the Chancery Court denied Edgen’s motion for a temporary restraining order to stop the plaintiff from proceeding in Louisiana, the Court noted that “the ability of plaintiff’s counsel to sue in multiple forums is a factor that imposes materially increased costs on deals and effectively disadvantages stockholders as a whole,” and recognized that corporations have properly adopted forum selection provisions in charters and bylaws in response “in an effort to reduce the ability of plaintiff’s counsel to extract rents.” The Court held that “[t]he forum selection provision in the charter is valid as a matter of Delaware corporate law,” and that “the [stockholder] here has

¹⁹⁵ Drawing an analogy to the shareholder rights plan, which, like the forum selection bylaw, was attacked as an excessive exercise of director authority, the Chancellor rejected plaintiffs’ “position that board action should be invalidated or enjoined simply because it involved a novel use of statutory authority.” The Court analogized its holding to the Delaware Supreme Court’s seminal decision authorizing poison pill rights plans in *Moran v. Household Int’l, Inc.*, 500 A.2d 1346 (Del. 1985), and wrote, “that a board’s action might involve a new use of plain statutory authority does not make it invalid under our law, and the boards of Delaware corporations have the flexibility to respond to changing dynamics in ways that are authorized by our statutory law.” The Court emphasized that forum-selection bylaws, like rights plans, are subject to challenge if applied inequitably, and further noted that, unlike rights plans, bylaws may be repealed by vote of the stockholders.

¹⁹⁶ 407 U.S. 1, 2 (1972).

¹⁹⁷ Frederick H. Alexander, James D. Honaker and Daniel D. Matthews, *Forum Selection Bylaws: Where We Are and Where We Go from Here*, 27 INSIGHTS 1: THE CORPORATE & SECURITIES LAW ADVISOR, Jul. 31, 2013.

¹⁹⁸ C.A. No. 9055-VCL (Del. Ch. Nov. 5, 2013) (Transcript).

facially breached the exclusive forum clause” by suing for alleged breaches of fiduciary duty outside of Delaware. Nevertheless, the Court observed that Edgen’s pursuit of an anti-suit injunction was “the most aggressive” path it could take and expressed concern that such a remedy “creates potential issues of interforum comity.” Citing Chancellor Strine’s decision in *Chevron*, the Court expressed a preference “that the forum selection provision would be considered in the first instance by . . . the court where the breaching party filed its litigation, not through an anti-suit injunction in the contractually specified court,” although the Court commented that “in the right case an anti-suit injunction [may be] appropriate.”

(d) Advance Notice and Director Qualification Provisions. Corporations desire to have advance notice of proposals and nominations that shareholders intend to request be included in their proxy materials or presented at a meeting of shareholders, and adopt provisions requiring advance notice thereof.¹⁹⁹ These advance notice provisions are commonplace in

¹⁹⁹ Set forth below are sample advance notice bylaw provisions for a Texas corporation:

2.9 Shareholders may nominate one or more persons for election as directors at any annual meeting of shareholders or propose other business to be brought before the annual meeting of shareholders, or both, only if (a) such business is a proper matter for shareholder action, (b) the shareholder gives timely notice in proper written form of such shareholder’s intention to make such nomination(s) or to propose such business, and (c) the shareholder is a shareholder of record of the corporation at the time of giving such notice and is entitled to vote at the annual meeting. The provisions of this Article II shall be the exclusive means for a shareholder to make nominations or submit other business (other than matters properly brought under Rule 14a-8 or Rule 14a-11 promulgated under the Securities Exchange Act of 1934, as amended (the “Exchange Act”), and included in the corporation’s proxy materials) at an annual meeting of shareholders.

2.10 Without qualification, for director nominations or any other business to be properly brought before an annual meeting of shareholders, a shareholder notice shall be delivered to and received by the secretary at the principal executive offices of the corporation not later than the close of business on the 90th day, and not earlier than the close of business on the 120th day, prior to the first anniversary of the preceding year’s annual meeting of shareholders; provided, however, that in the event that the date of the annual meeting has changed by more than thirty (30) days from the date of the previous year’s annual meeting, notice by the shareholder to be timely must be so delivered and received not earlier than the close of business on the 120th day prior to such annual meeting and not later than the close of business on the later of (a) the 90th day prior to such annual meeting, and (b) the 10th day following the date on which public announcement of the date of such meeting is first made by the corporation. In no event shall the public announcement of an adjournment or postponement of an annual meeting commence a new time period for the giving of a shareholder notice as described above. For purposes of this Article II, “public announcement” shall mean disclosure in a press release reported by Dow Jones News Service, Associated Press or a comparable national news service, in a document publicly filed by the corporation with the Securities and Exchange Commission, or in a notice pursuant to the applicable rules of an exchange on which the corporation’s securities are listed. To be in proper written form, the shareholder notice must comply with Section 2.12 below.

2.11 Only such business shall be conducted at a special meeting of shareholders as shall have been brought before the meeting pursuant to the notice of meeting. Nominations of persons for election to the board of directors may be made at a special meeting of shareholders at which directors are to be elected pursuant to the notice of meeting (a) by or at the direction of the board of directors or (b) by any shareholder of the corporation pursuant to Rule 14a-11 promulgated under the Exchange Act who (1) is a shareholder of record at the time of giving such notice (2) is entitled to vote at the meeting, and (3) provides timely notice

as to such nomination in the proper written form. In the event the corporation calls a special meeting of shareholders for the purpose of electing one or more directors to the board of directors, any shareholder meeting the requirements of the previous sentence may nominate a person or persons (as the case may be), for election to such position(s) as specified in the corporation's notice of meeting, if the shareholder notice with respect to any nomination (including the completed and signed questionnaire and representation and agreement required by Section 2.15 below) shall be delivered to the secretary at the principal executive offices of the corporation not earlier than the close of business on the 90th day prior to the date of such special meeting and not later than the close of business on the later of (a) the 70th day prior to the date of such special meeting, and (b) if the first public announcement of the date of such special meeting is less than 80 days prior to the date of such special meeting, the 10th day following the day on which public announcement is first made of the date of the special meeting and of any nominees proposed by the board of directors to be elected at such meeting. In no event shall the public announcement of an adjournment or postponement of a special meeting commence a new time period for the giving of a shareholder notice as described above.

2.12 To be in proper written form, a shareholder notice (whether given pursuant to Section 2.3 above, Sections 2.9 and 2.10 above with respect to annual meetings or Section 2.11 above with respect to special meetings) to the secretary must be in writing and:

(a) set forth, as to the shareholder giving the notice and the beneficial owner, if any, on whose behalf the director nomination or proposal of other business is made (i) the name and address of such shareholder, as they appear on the corporation's books, and of such beneficial owner, (ii) (1) the class and number of shares of the corporation which are, directly or indirectly, owned beneficially and of record by such shareholder and such beneficial owner, (2) any option, warrant, convertible security, stock appreciation right, or similar right with an exercise or conversion privilege or a settlement payment or mechanism at a price related to any class of shares of the corporation or with a value derived in whole or in part from the value of any class of shares of the corporation, whether or not such instrument or right shall be subject to settlement in the underlying class of capital stock of the corporation or otherwise (a "Derivative Instrument") directly or indirectly owned beneficially by such shareholder or beneficial owner and any other direct or indirect economic interest held or owned beneficially by such shareholder or beneficial owner to profit or share in any profit derived from any increase or decrease in the value of shares of the corporation, (3) any proxy, contract, arrangement, understanding, or relationship pursuant to which such shareholder or beneficial owner has a right to vote any shares of any security of the corporation, (4) any short interest in any security of the corporation (for purposes of this Section 2.12, a person shall be deemed to have a short interest in a security if such person, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, has the opportunity to profit or share in any profit derived from any decrease in the value of the subject security), (5) any rights to dividends on the shares of the corporation owned beneficially by such shareholder or beneficial owner that are separated or separable from the underlying shares of the corporation, (6) any proportionate interest in shares of the corporation or Derivative Instruments held, directly or indirectly, by a general or limited partnership in which such shareholder or beneficial owner is a general partner or, directly or indirectly, beneficially owns an interest in a general partner, and (7) any performance-related fees (other than an asset-based fee) that such shareholder or beneficial owner is entitled to based on any increase or decrease in the value of shares of the corporation or Derivative Instruments, if any, as of the date of such notice including, without limitation, any such interests held by members of such shareholder's or beneficial owner's immediate family sharing the same household (which information shall be updated and supplemented by such shareholder and beneficial owner (A) as of the record date, (B) ten days before the meeting, and (C) immediately prior to the commencement of the meeting), and (iii) any other information relating to such shareholder and beneficial owner that would be required to be disclosed in a proxy statement or other filings required to be made in connection with solicitations of proxies for, as applicable, the proposal and/or for the

election of directors in a contested election pursuant to Section 14 of the Exchange Act and the rules and regulations promulgated thereunder;

(b) if the notice relates to any business other than a nomination of a director or directors that the shareholder proposes to bring before the meeting, set forth (i) a brief description of the business desired to be brought before the meeting, the reasons for conducting such business at the meeting and any material interest of such shareholder and beneficial owner, if any, in such business and (ii) a description of all agreements, arrangements and understandings between such shareholder and beneficial owner, if any, and any other person or persons (including their names) in connection with the proposal of such business by such shareholder;

(c) if the notice relates to the nomination of a director or directors, (i) set forth with respect to each nominee, (1) all information relating to such nominee that would be required to be disclosed in a proxy statement or other filings required to be made in connection with solicitations of proxies for election of directors in a contested election pursuant to Section 14 of the Exchange Act and the rules and regulations promulgated thereunder (including such nominee's written consent to being named in a proxy statement as a nominee and to serving as a director of the corporation if elected) and (2) a description of all direct and indirect compensation and other material monetary agreements, arrangements and understandings during the past three years, and any other material relationships, between or among such shareholder and beneficial owner, if any, and their respective affiliates and associates, or others acting in concert therewith, on the one hand, and each proposed nominee, and his or her respective affiliates and associates, or others acting in concert therewith, on the other hand, including, without limitation, all information that would be required to be disclosed pursuant to Rule 404 promulgated under Regulation S-K (or any successor rule) if the shareholder making the nomination and any beneficial owner on whose behalf the nomination is made, or any affiliate or associate thereof or person acting in concert therewith, were the "registrant" for purposes of such rule and the nominee were a director or executive officer of such registrant, and (ii) with respect to each nominee, include a completed, dated and signed written questionnaire and written representation and agreement and any other information required by Section 2.15 below.

2.13 Notwithstanding anything in the first sentence of Section 2.10 to the contrary, in the event that the number of directors to be elected to the board of directors of the corporation is increased and there is no public announcement by the corporation naming all of the nominees for director or specifying the size of the increased board of directors at least 90 days prior to the first anniversary of the preceding year's annual meeting, a shareholder notice required by Section 2.10 shall also be considered timely, but only with respect to nominees for any new positions created by such increase, if it shall be delivered to the secretary at the principal executive offices of the corporation not later than the close of business on the 10th day following the day on which such public announcement is first made by the corporation.

2.14 General.

(a) Only such persons who are nominated as directors in accordance with the procedures set forth in Sections 2.9, 2.10, 2.11, 2.12, 2.13, 2.14 and 2.15 shall be eligible to be elected at an annual or special meeting of shareholders to serve as directors and only such other business shall be conducted at an annual or special meeting of shareholders as shall have been brought before the meeting in accordance with the procedures set forth in Sections 2.9, 2.10, 2.11, 2.12, 2.13 and 2.14. Except as otherwise provided by law, the Articles of Incorporation or these Bylaws, the person presiding over the meeting shall have the power and duty to determine whether a director nomination or any other business proposed to be brought before the meeting was made or proposed, as the case may be, in accordance with the procedures set forth in Sections 2.9, 2.10, 2.11, 2.12, 2.13, 2.14 and 2.15 and, if any proposed director nomination or other business is not in compliance with Sections 2.9, 2.10, 2.11, 2.12, 2.13, 2.14 and 2.15, to declare that such defective nomination or other proposal shall be disregarded.

Delaware.²⁰⁰ These types bylaws have been construed often by Delaware courts.²⁰¹ Generally, advance notice provisions have been upheld under Delaware law so long as they do not unduly restrict the shareholder franchise and are not applied inequitably.²⁰²

Following the mandate of Dodd-Frank, the SEC adopted new proxy access rules.²⁰³ Of specific application to advance notice bylaws is Rule 14a-11 under the 1934 Act, which governs the requirements for shareholders to be able to include director nominees on a company's proxy

(b) Notwithstanding the foregoing provisions of Sections 2.9, 2.10, 2.11, 2.12, 2.13 and 2.14, a shareholder shall also comply with all applicable requirements of the Exchange Act and the rules and regulations thereunder with respect to nominations of one or more persons for election as directors or proposals of other business to be brought before an annual or special meeting of shareholders. Nothing in Sections 2.9, 2.10, 2.11, 2.12, 2.13, 2.14 and 2.15 shall be deemed to affect any rights of (i) shareholders to request inclusion of proposals in the corporation's proxy statement pursuant to Rule 14a-8 under the Exchange Act, (ii) shareholders to request inclusion of nominees in the corporation's proxy statement pursuant to Rule 14a-11 under the Exchange Act, or (iii) the holders of any series of Preferred Stock if and to the extent provided for under law, the Articles of Incorporation or these Bylaws.

²⁰⁰ *Openwave Sys. v. Harbinger Capital Partners Master Fund I, Ltd.*, 924 A.2d 228, 238-39 (Del. Ch. 2007); *Stroud v. Grace*, 606 A.2d 75, 95 (Del. 1992) (upholding advance bylaw provisions); *Accipiter Life Scis. Fund, L.P. v. Heifer*, 905 A.2d 115, 127 (Del. Ch. 2006) (upholding validity of 10 day advance notice provision); see *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1388 n. 38 (Del. 1995) (bylaws upheld in hostile takeover situation).

²⁰¹ *Id.*

²⁰² *Goggin v. Vermillion, Inc.*, C.A. No. 6465-VCN, 2011 Del. Ch. LEXIS 80, at *13 (Del. Ch. June 3, 2011) (“Advance notice requirements are ‘commonplace’ and ‘are often construed and frequently upheld as valid by Delaware courts.’ They are useful in permitting orderly shareholder meetings, but if notice requirements ‘unduly restrict the stockholder franchise or are applied inequitably, they will be struck down.’”). *Goggin* was quoted and followed in *AB Value Partners, LP v. Kreisler Manufacturing Corp.*, C.A. No. 10434-VCP (Del. Ch. Dec. 16, 2014), in which the court declined to issue a temporary restraining order (“*TRQ*”) enjoining the advance notice bylaw of Kreisler Manufacturing Corporation so that AB Value (an activist hedge fund that owned 11.1% of Kreisler) could run a competing slate of directors at Kreisler's annual stockholder meeting. In so holding, the court explained that Delaware courts will enjoin an advance notice bylaw (i) if the bylaw is adopted or applied to thwart a dissident stockholder by making compliance impossible or extremely difficult (the court said such was not the situation present as Kreisler had adopted the bylaw on a “clear day” long before the AB Value proxy contest had been contemplated), and the validity of the bylaw on its face was not in question; (ii) if the bylaw is ambiguous, which was not the case with the Kreisler bylaw; or (iii) if the Board causes a material change in circumstances after the notice deadline. The court found that the changes at Kreisler during the period between the notice deadline and the annual meeting had not been caused by the Board and were not sufficiently material to have represented a “radical shift” in the direction of the company. AB Value had argued that the following changes supported equitable relief: (a) shares that had been held in trust were distributed to the trust beneficiaries, which gave AB Value a better chance of winning a proxy contest, and which the court found was merely a change in stockholder composition (in the court's view, a common occurrence for companies) and in no way “substantially alter[ed] the direction of the company”; and (b) the Board had increased the annual salary for the two co-Presidents from \$175,000 per year to \$275,000, which the court found had been unanimously approved by the Board and “neither the operations of the Company nor its business direction [were] changed” as a result of the increase. The court distinguished two precedents, in which the Chancery Court had granted equitable relief after finding that changes by the Board during the post-deadline/pre-annual meeting period constituted a “radical shift” in the direction of the company—involving, in one case, a Board's sudden support for a new dissident director's plan to transform the company, and, in the other, a Board's sudden change of view regarding a sale of the company.

²⁰³ SEC Release Nos. 33-9136; 34-62764; IC-29384; File No. S7-10-09 at 22 (Aug. 25, 2010).

materials.²⁰⁴ However, in order for a shareholder to be able to use Rule 14a-11 to include a nominee on a company's proxy materials, the shareholder must have a state law right to nominate a director.²⁰⁵ SEC staff members have said that the SEC's position on the matter is that advance notice bylaws cannot be ignored.²⁰⁶ The reason for this position is that compliance with an advance notice bylaw is a prerequisite for having a state law right to nominate a director.²⁰⁷ Therefore, if an advance notice bylaw is not complied with by a shareholder in attempting to nominate a director, then the fact of non-compliance can be used to preclude the nomination of the candidate not only at the meeting but also from the proxy entirely assuming they complied with the SEC process for excluding nominees from the proxy.

Another type of provision that can potentially be used to reduce the risk that unqualified nominees are elected is a provision that sets forth minimum qualifications for directors.²⁰⁸

²⁰⁴ Rule 14a-11 is currently stayed pending the resolution of the Business Roundtable and Chamber of Commerce petition for review of the rule in the D.C. Circuit. Resolution of the case is expected sometime in the spring of 2011.

²⁰⁵ See J.W. Verret, *Defending Against Shareholder Proxy Access: Delaware's Future Reviewing Company Defenses in the Era of Dodd-Frank*, 36 J. CORP. L. 101 (2010).

²⁰⁶ Cydney Posner, *Proxy Access Update Regarding the Application of Advance Notice Bylaws and Other Limitations on Nominations* (Sept. 20, 2010), <http://www.cooley.com/64333>.

²⁰⁷ *Id.*

²⁰⁸ Set forth below are sample director qualifications provisions for a Texas corporation:

2.15 To be eligible to be a nominee for election as a director of the corporation (or, in the case of a nomination brought under Rule 14a-11 of the Exchange Act, to serve as a director of the corporation), the nominee must deliver (in accordance with the time periods prescribed for delivery of notice under Sections 2.10, 2.11 and 2.13 or, in the case of a nomination brought under Rule 14a-11 of the Exchange Act, prior to the time such person is to begin service as a director) to the secretary at the principal executive offices of the corporation a written questionnaire with respect to the background and qualification of such nominee and the background of any other person or entity on whose behalf the nomination is being made (which form of questionnaire shall be provided by the secretary upon written request) and a written representation and agreement (in the form provided by the secretary upon written request) that such nominee (a) is not and will not become a party to (i) any agreement, arrangement or understanding with, and has not given any commitment or assurance to, any person or entity as to how such nominee, if elected as a director of the corporation, will act or vote on any issue or question (a "Voting Commitment") that has not been previously disclosed in writing to the corporation or (ii) any Voting Commitment that could limit or interfere with such nominee's ability to comply, if elected as a director of the corporation, with such nominee's fiduciary duties under applicable law, (b) is not and will not become a party to any agreement, arrangement or understanding with any person or entity other than the corporation with respect to any direct or indirect compensation, reimbursement or indemnification in connection with service or action as a director that has not been previously disclosed in writing to the corporation, and (c) in such nominee's individual capacity and on behalf of any person or entity on whose behalf the nomination is being made, would be in compliance, if elected as a director of the corporation, and will comply with all applicable corporate governance, conflict of interest, confidentiality and stock ownership and trading policies and guidelines of the corporation. The corporation may also require such nominee to furnish such other information as may reasonably be required by the corporation to determine the eligibility of such nominee to serve as an independent director of the corporation or that could be material to a reasonable shareholder's understanding of the independence, or lack thereof, of such nominee.

Delaware courts seem to permit these provisions to require minimum length of experience, type of experience by industry, type of experience by institution, type of experience by level of authority, certain professional degrees or certifications, minimum educational background, and conflict limitations. For example, a director qualification charter amendment requiring that a majority of directors have “substantial experience in line (as distinct from staff) positions in the management of substantial business enterprises or substantial private institutions, who are not officers, employees or stockholders, whether of record or beneficially, of the corporation or any of its subsidiaries” was upheld by the Delaware Supreme Court.²⁰⁹ Another common requirement is that the director must own stock in the corporation. As long as the director qualifications are applied on the front end, prior to a director being qualified, rather than on the back end in an attempt to unseat a previously qualified director, director qualification provisions would seem to pass muster under Delaware law.²¹⁰

Under Texas law, director qualification provisions in either the certificate of formation or bylaws are authorized by TBOC § 21.402.²¹¹ However, there is no available Texas case law construing one of these certificate amendments or bylaws.

The relationship between director qualification bylaws and Rule 14a-11 is more complex than for advance notice bylaws. If the bylaws only govern a directors ability to serve as a director, then the nominee must be included on the proxy statement even if they do not satisfy the qualifications although the board could refuse to seat the director.²¹² But, if the bylaws are phrased to prevent the director from even being nominated (as the bylaw example given in the footnotes is), then the director could be excluded from the proxy material under the same logic as advance notice bylaws. In order to be able to exclude the director from the proxy materials, the company would need to show the SEC that the qualification was generally applicable across the

3.5 When considering any nominations by shareholders for members of the board of directors, the board, or a committee thereof may, in its discretion, consider the qualifications of any such nominees to serve as directors. Such qualifications shall include, but not be limited to, factors such as independence, judgment, skill, diversity, experience with businesses and other organizations of comparable size to the corporation, experience as an officer of a publicly traded company, the interplay of the candidate’s experience with the experience of other board members and the extent to which the candidate would be a desirable addition to the board of directors and any committees thereof and assessment of the diversity of the candidate’s background, viewpoints, training, professional experience, education and skill set. Subject to Rule 14a-11 promulgated under the Exchange Act, the board, or any committee thereof, may preclude any nominees from serving on the board of directors if the board or such committee, determines in good faith that such nominee does not satisfy the qualifications established by the board or any committee thereof.

²⁰⁹ *Stroud v. Grace*, 606 A.2d 75, 93 (Del. 1992).

²¹⁰ *Kurz v. Holbrook*, 989 A.2d 140, 144 (Del. Ch. 2010) (*reversed in part on other grounds by Crown EMAK Partners, LLC v. Kurz*, 992 A.2d 377 (Del. 2010)).

²¹¹ TBOC § 21.402 provides as follows:

Sec. 21.402. BOARD MEMBER ELIGIBILITY REQUIREMENTS. Unless the certificate of formation or bylaws of a corporation provide otherwise, a person is not required to be a resident of this state or a shareholder of the corporation to serve as a director. The certificate of formation or bylaws may prescribe other qualifications for directors.

²¹² Cydney Posner, *Proxy Access Update Regarding the Application of Advance Notice Bylaws and Other Limitations on Nominations* (Sept. 20, 2010), <http://www.cooley.com/64333>.

board, not one that could be satisfied prior to nomination (such as the condition of owning shares listed above), and that the qualification would be valid under state law.²¹³ However, SEC staff members have suggested that the SEC staff would look askance at a bylaw provision that looked like an “opt out” of Rule 14a-11 (there is no opt out allowed under the rule) such as by preventing anyone from being nominated during the open window period for proxy access nominations.²¹⁴

(e) Fee-shifting Bylaws. “Fee-shifting bylaws” are provisions in a corporation’s bylaws that provide that if a stockholder sues the corporation or another stockholder, the claimant is obligated to pay all fees and other costs of the party against whom the claim is made unless the claimant prevails in the litigation. In *ATP Tour, Inc. v. Deutscher Tennis Bund*,²¹⁵ the Delaware Supreme Court, in answering certified questions from the United States Court of Appeals for the Third Circuit, wrote that fee-shifting bylaws can be valid under the DGCL. The certified questions of law concerned the validity of a provision in a Delaware non-stock corporation’s bylaws, which the directors had adopted pursuant to their charter-delegated power to unilaterally amend the bylaws, that shifted attorneys’ fees and costs to unsuccessful plaintiffs in intra-corporate litigation. The Delaware Supreme Court held “that fee-shifting provisions in a non-stock corporation’s bylaws can be valid and enforceable under Delaware law” and that “bylaws normally apply to all members of a non-stock corporation regardless of whether the bylaw was adopted before or after the member in question became a member.”²¹⁶

The Supreme Court explained its conclusion that fee-shifting bylaws are permissible under Delaware law as follows:

The first certified question asks whether the board of a Delaware non-stock corporation may lawfully adopt a bylaw that shifts all litigation expenses to a plaintiff in intra-corporate litigation who “does not obtain a judgment on the merits that substantially achieves, in substance and amount, the full remedy sought.” Under Delaware law, a corporation’s bylaws are “presumed to be valid, and the courts will construe the bylaws in a manner consistent with the law rather than strike down the bylaws.” To be facially valid, a bylaw must be authorized by

²¹³ *Id.*

²¹⁴ *Id.*

²¹⁵ 91 A.3d 554, 555 (Del. May 8, 2014).

²¹⁶ The fee-shifting bylaw at issue in *ATP Tour* provided in relevant part:

(a) In the event that (i) any [current or prior member or Owner or anyone on their behalf (“Claiming Party”)] initiates or asserts any [claim or counterclaim (“Claim”)] or joins, offers substantial assistance to or has a direct financial interest in any Claim against the League or any member or Owner (including any Claim purportedly filed on behalf of the League or any member), and (ii) the Claiming Party (or the third party that received substantial assistance from the Claiming Party or in whose Claim the Claiming Party had a direct financial interest) does not obtain a judgment on the merits that substantially achieves, in substance and amount, the full remedy sought, then each Claiming Party shall be obligated jointly and severally to reimburse the League and any such member or Owners for all fees, costs and expenses of every kind and description (including, but not limited to, all reasonable attorneys’ fees and other litigation expenses) (collectively, “Litigation Costs”) that the parties may incur in connection with such Claim.

the Delaware General Corporation Law (DGCL), consistent with the corporation's certificate of incorporation, and its enactment must not be otherwise prohibited. That, under some circumstances, a bylaw might conflict with a statute, or operate unlawfully, is not a ground for finding it facially invalid.

A fee-shifting bylaw, like the one described in the first certified question, is facially valid. Neither the DGCL nor any other Delaware statute forbids the enactment of fee-shifting bylaws. A bylaw that allocates risk among parties in intra-corporate litigation would also appear to satisfy the DGCL's requirement that bylaws must "relat[e] to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees." The corporate charter could permit fee-shifting provisions, either explicitly or implicitly by silence. Moreover, no principle of common law prohibits directors from enacting fee-shifting bylaws.

Delaware follows the American Rule, under which parties to litigation generally must pay their own attorneys' fees and costs. But it is settled that contracting parties may agree to modify the American Rule and obligate the losing party to pay the prevailing party's fees. Because corporate bylaws are "contracts among a corporation's shareholders," a fee-shifting provision contained in a non-stock corporation's validly-enacted bylaw would fall within the contractual exception to the American Rule. Therefore, a fee-shifting bylaw would not be prohibited under Delaware common law.

Whether the specific ATP fee-shifting bylaw is enforceable, however, depends on the manner in which it was adopted and the circumstances under which it was invoked. Bylaws that may otherwise be facially valid will not be enforced if adopted or used for an inequitable purpose. In the landmark *Schnell v. Chris-Craft Industries* [285 A.2d 437 (Del. 1971)] decision, for example, this Court set aside a board-adopted bylaw amendment that moved up the date of an annual stockholder meeting to a month earlier than the date originally scheduled. The Court found that the board's purpose in adopting the bylaw and moving the meeting was to "perpetuat[e] itself in office" and to "obstruct[] the legitimate efforts of dissident stockholders in the exercise of their rights to undertake a proxy contest against management." The *Schnell* Court famously stated that "inequitable action does not become permissible simply because it is legally possible."

More recently, in *Hollinger International, Inc. v. Black* [844 A.2d 1022 (Del. Ch. 2004), aff'd sub. nom., *Black v. Hollinger Int'l Inc.*, 872 A.2d 559 (Del. 2005)], the Court of Chancery addressed bylaw amendments, enacted by a controlling shareholder, that prevented the board "from acting on any matter of significance except by unanimous vote" and "set the board's quorum requirement at 80%," among other changes. The Court of Chancery found, and this Court agreed, that the bylaw amendments were ineffective because they "were clearly adopted for an inequitable purpose and have an inequitable effect." That finding

was based on an extensive review of the facts surrounding the controller's decision to amend the bylaws.

Conversely, this Court has upheld similarly restrictive bylaws that were enacted for proper purposes. In *Frantz Manufacturing Co. v. EAC Industries*, a majority stockholder amended the corporation's bylaws by written consent in order to "limit the [] board's anti-takeover maneuvering after [the stockholder] had gained control of the corporation." The amended bylaws, like those invalidated in *Hollinger*, increased the board quorum requirement and mandated that all board actions be unanimous. The Court found that the bylaw amendments were "a permissible part of [the stockholder's] attempt to avoid its disenfranchisement as a majority shareholder" and, thus, were "not inequitable under the circumstances."

In sum, the enforceability of a facially valid bylaw may turn on the circumstances surrounding its adoption and use.²¹⁷

2.3. Business Combinations.

2.3.1. Statutory Framework: Board and Shareholder Action. Both Texas and Delaware law permit corporations to merge with other corporations and alternative entities by adopting a plan of merger and obtaining the requisite Board and shareholder approval ("long-form merger").²¹⁸ Both Texas and Delaware permit a merger to be effected without shareholder approval if the corporation is the sole surviving corporation, the shares of stock of the corporation are not changed as a result of the merger and the total number of shares of stock issued pursuant to the merger does not exceed 20% of the shares of the corporation outstanding immediately prior to the merger.²¹⁹

(a) Texas. TBOC § 21.452 provides that for a corporation that is party to a merger to approve a merger, the corporation's Board shall adopt a resolution that (i) approves the plan of merger and (ii) if shareholder approval is required, either (A) recommends that the plan of merger be approved by the shareholders or (B) directs that the plan of merger be submitted to the shareholders without recommendation if the Board for any reason determines not to recommend approval of the plan of merger. The Board must communicate to the shareholders the reason for submitting a plan of merger for shareholder vote without a recommendation.²²⁰ Further, if after adopting a resolution approving a merger the Board determines that the plan of merger is not advisable, the plan of merger may be submitted to the shareholders with a recommendation that the shareholders not approve the plan²²¹ A plan of merger may contain a provision requiring that it be submitted for shareholder vote regardless of whether the Board subsequently changes its

²¹⁷ *ATP*, 91 A.3d at 557-59.

²¹⁸ See TBOC §§ 10.001, 21.452; TBCA art. 5.01; DGCL §§ 251-58; 263 (partnerships); 264 (LLCs); see generally Curtis W. Huff, *The New Texas Business Corporation Act Merger Provisions*, 21 ST. MARY'S L.J. 109 (1989).

²¹⁹ TBOC § 21.459; TBCA art. 5.03(G); DGCL § 251(f).

²²⁰ TBOC § 21.452(d).

²²¹ TBOC § 21.452(f).

recommendation and recommends that the shareholders vote against approving the plan of merger.²²² The TBOC permits shareholder action on a merger by unanimous written consent²²³ or, if the certificate of incorporation so provides, by the shareholders having the minimum number of shares required to approve the merger.²²⁴ The Tex. Corp. Stats.' allowance of directors to submit a plan of merger to shareholders without recommendation is intended to address those few circumstances in which a Board may consider it appropriate for shareholders to be given the right to vote on a plan of merger, but for fiduciary or other reasons the Board has concluded that it would not be appropriate for the Board to make a recommendation.²²⁵ Under Texas law, approval of a long-form merger will generally require approval of the holders of at least two-thirds of the outstanding shares entitled to vote on the merger, although (as with other fundamental transactions) the Tex. Corp. Stats. permit a corporation's certificate of formation to reduce the required vote to an affirmative vote of the holders of not less than a majority of the outstanding shares.²²⁶

TBOC § 10.006 permits a short-form merger in which a parent entity owning at least 90% of each class of shares of the target entitled to vote on a merger may effect such merger without any action by the Board or stockholders of the target.

(b) Delaware. Delaware law requires that the Board approve the agreement of merger and declare its advisability, and then submit the merger agreement to the stockholders for the purpose of their adopting the agreement.²²⁷ Delaware law provides that mergers may be approved by a vote of the holders of a majority of the outstanding shares.²²⁸ Delaware permits a merger agreement to contain a provision requiring that the agreement be submitted to the stockholders whether or not the Board determines at any time subsequent to declaring its advisability that the agreement is no longer advisable and recommends that the stockholders reject it.²²⁹

Under DGCL § 228, a merger may be approved without a meeting by the written consent of the holders of not less than the minimum number of shares required to approve the merger.

DGCL § 267 also permits a short-form merger in which a parent entity owning at least 90% of each class of shares of the target entitled to vote on a merger may effect such merger without any action by the Board or stockholders of the target, although receiving tenders from holders of 90% of the outstanding shares of a public company may be difficult, given the presence of non-responsive, and possible opposition, by even a small minority of the

²²² TBOC § 21.452(g).

²²³ TBOC § 6.201.

²²⁴ TBOC § 6.202.

²²⁵ Byron F. Egan & Curtis W. Huff, *Choice of State of Incorporation – Texas versus Delaware: Is It Now Time To Rethink Traditional Notions?*, 54 SMU L. REV. 249, 282 (2001).

²²⁶ TBOC § 21.365(a); TBCA art. 2.28.

²²⁷ See DGCL § 251(b), (c) (2013).

²²⁸ Compare TBOC §§ 21.452, 21.457, and TBCA art. 5.03(E), with DGCL § 251(c).

²²⁹ DGCL § 146.

stockholders.²³⁰ DGCL § 251(h) permits a merger agreement to contain a provision obviating the need for a stockholder vote (and, thus, the concomitant delay) for a back-end long-form merger following consummation of a tender offer if certain conditions are met. Specifically, DGCL § 251(h) specifies that, unless otherwise required by the target corporation's certificate of incorporation, no vote of stockholders of the target corporation is necessary to authorize a merger with another corporation if the target corporation's shares are listed on a national securities exchange or held of record by more than 2,000 holders, and the following additional conditions are satisfied: (i) the merger agreement expressly provides the merger may be governed by DGCL § 251(h) and shall be effected as soon as practicable following the consummation of the first-step tender offer; (ii) the purchaser consummates a tender offer for all of the outstanding stock of the target corporation that is not owned by the target corporation, the acquiring corporation, or any of their subsidiaries, and that absent DGCL § 251(h), would be entitled to vote on the adoption of the merger; (iii) following the consummation of the offer, a sufficient percentage of the target corporation's stock, and of each class and series thereof, is owned by the purchaser (or is otherwise received by a depository prior to the expiration of such offer) as required by the DGCL to adopt the merger agreement or any higher threshold required by the target's certificate of incorporation; (iv) the purchaser merges with or into the target corporation; and (v) the same amount and kind of consideration is paid to the target stockholders in the back-end merger as offered in the first-step tender offer.

Under Delaware law, if a corporation's stockholders are asked to vote on a merger agreement, its Board has a duty to disclose its up-to-date views on the merger.²³¹ Directors are legally constrained from engaging in "contractual attempts to circumscribe [their] ability . . . to fulfill their fiduciary duties."²³² As a result, merger agreements often contain a change of recommendation provision that allows the Board to change its recommendation that stockholders

²³⁰ To avoid the delay associated with a long-form back-end merger following the tender offer, while making the minimum tender necessary to effect a short-form merger more realistically obtainable, two potential solutions were developed: (1) the SEC adopted Rule 14d-11, authorizing a subsequent offering period, in part to "assist bidders in reaching the statutory state law minimum necessary to engage in a short-form, back-end merger with the target," and (2) a top-up option which permits a bidder in a tender offer to acquire ownership of 90% of the outstanding shares of the target's stock even though it owns less than 90% after completion of the tender offer. Such an option permits an acquiror that has consummated the front-end tender offer to "top-up" its ownership of target stock to 90% to permit a short-form merger by purchasing newly issued or treasury shares. The effectiveness of a top-up option, however, is dependent upon the number of authorized but unissued or treasury shares the target has. As a rule of thumb, for every 1% that an acquiror's ownership falls short of the 90% short-form threshold, a number of target shares equal to 10% of the target's outstanding stock prior to the offer must be issued to the acquiror under the top-up option.

²³¹ See *Frontier Oil Corp. v. Holly Corp.*, C.A. No. 20502-VCN, 2005 WL 1039027, at *27 and *28 (Del. Ch. Apr. 29, 2005) (noting that ("[b]efore the [m]erger could occur the shareholders . . . had to approve it. The directors . . . were under continuing fiduciary duties to the shareholders to evaluate the proposed transaction"). *Id.* at *28 ("Revisiting the commitment to recommend the [m]erger was not merely something that the [m]erger [a]greement allowed the . . . Board to do; it was the duty of the . . . Board to review the transaction to confirm that a favorable recommendation would continue to be consistent with its fiduciary duties.") (emphasis added).

²³² *Energy Partners, Ltd. v. Stone Energy Corp.*, C.A. Nos. 2374-N, 2402-N, 2006 Del. Ch. LEXIS 182 (Del. Ch. Oct. 11, 2006).

vote in favor of the agreement when a Board's fiduciary duties so require or in response to a superior proposal or an intervening event.²³³

2.4. Owner Liability Issues. Limited liability is one of the most important advantages of doing business as a corporation. In corporate law, it is fundamental that shareholders, officers, and directors are ordinarily protected from personal liability arising from the activities of the corporation.²³⁴ This insulation from personal liability is said to be the natural consequence of the incorporation process, and is supported by the theory or "fiction" that incorporation results in the creation of an "entity" separate and distinct from the individual shareholders.²³⁵ While this general rule of nonliability is given great deference by the courts, there are circumstances under which personal liability may be imposed on the shareholders, officers, or directors of a corporation.

Generally, shareholders of a corporation will not be personally liable for debts and obligations of the corporation in excess of the shareholder's investment in the corporation. In exceptional situations, a court will "pierce the corporate veil" or "disregard the corporate entity" to find a shareholder personally liable for the activities of the corporation. In *Castleberry v. Branscum*,²³⁶ the Texas Supreme Court enumerated circumstances under which the corporate entity may be disregarded, including, among others, (1) when the corporate fiction is used as a means of perpetrating fraud, (2) where a corporation is organized and operated as a mere tool or business conduit (the "alter ego") of another corporation (or person), (3) where the corporate fiction is resorted to as a means of evading an existing legal obligation, (4) where the corporate fiction is used to circumvent a statute, and (5) where the corporate fiction is relied upon as a protection of crime or to justify wrong. TBCA article 2.21 was subsequently amended to overrule *Castleberry* and define the circumstances under which a court may pierce the corporate veil in contract cases.²³⁷

²³³ See *supra* note 539.

²³⁴ *Willis v. Donnelly*, 199 S.W.3d 262, 271 (Tex. 2006) ("A bedrock principle of corporate law is that an individual can incorporate a business and thereby normally shield himself from personal liability for the corporation's contractual obligations."); see Elizabeth S. Miller, *Are There Limits on Limited Liability? Owner Liability Protection and Piercing the Veil of Texas Business Entities*, 43 TEX. J. BUS. L. 405, 406-416 (Fall 2009).

²³⁵ *Delaney v. Fid. Lease Ltd.*, 517 S.W.2d 420, 423 (Tex. Civ. App.—El Paso 1974), *aff'd in part and rev'd in part on other grounds*, 526 S.W.2d 543 (Tex. 1975); *Sutton v. Reagan & Gee*, 405 S.W.2d 828 (Tex. Civ. App.—San Antonio 1966, writ ref'd n.r.e.).

²³⁶ *Castleberry v. Branscum*, 721 S.W.2d 270, 272 (Tex. 1986).

²³⁷ *Castleberry* was cited by the Texas Supreme Court in *In re Smith*, 192 S.W.3d 564, 568-69 (Tex. 2006), which held that the *alter ego theory* was relevant in a post-judgment proceeding for determining a defendant's net worth for the purposes of determining the amount of security required to suspend enforcement of a judgment (under Texas law the security required may not exceed the lesser of 50% of the judgment debtor's net worth or \$25 million):

Because "[a]lter ego applies when there is such unity between corporation and individual that the separateness of the corporation has ceased," *Castleberry v. Branscum*, 721 S.W.2d 270, 272 (Tex.1986), an alter ego finding is relevant to the determination of the judgment debtor's net worth. * * *

Although the trial court did not abuse its discretion by considering the alter ego theory, that does not mean that the trial court's alter ego finding may be used to hold R.A. Smith &

Under TBCA article 2.21, as amended, as well as the parallel provision in TBOC section 21.223, no shareholder, or affiliate of the shareholder or the corporation, may be held liable for (i) any contractual obligation of the corporation on the basis that the shareholder or affiliate is or was the alter ego of the corporation or on the basis of actual or constructive fraud, a sham to perpetuate a fraud or a similar theory, unless it is shown that the shareholder used the corporation for the purpose of perpetrating, and did perpetrate, an actual fraud, primarily for the personal benefit of the shareholder or affiliate or (ii) any obligation (whether contractual, tort or other) on the basis that the corporation failed to observe any corporate formality (e.g., maintaining separate offices and employees, keeping separate books, holding regular meetings of shareholders and board of directors, keeping written minutes of such meetings, etc.).²³⁸ Several Texas cases have confirmed that TBCA article 2.21 is the exclusive means for piercing the corporate veil of a Texas corporation for the types of cases referenced and that actual fraud is a prerequisite thereunder.²³⁹

Company, Inc. or any other nonparty liable for the judgment. A judgment may not be amended to include an alter ego that was not named in the suit. *Matthews Const. Co., Inc. v. Rosen*, 796 S.W.2d 692, 693 (Tex.1990). Therefore, an alter ego finding in a post-judgment net worth proceeding may not be used to enforce the judgment against the unnamed alter ego or any other non-judgment debtor, but only to determine the judgment debtor's net worth for the purposes of Rule 24.

²³⁸ TBCA art. 2.21 (emphasis added). Some courts continue to ignore TBCA art. 2.21, perhaps because the litigants fail to bring it to the attention of the court, and cite *Castleberry* as authority. See, e.g., *Cementos de Chihuahua, S.A. de C.V. v. Intermodal Sales Corp.*, 162 S.W.3d 581, 586-87 (Tex. App.—El Paso 2005, no pet.).

²³⁹ *S. Union Co. v. City of Edinburg*, 129 S.W.3d 74 (Tex. 2003) (the Texas Supreme Court repudiated the single business enterprise doctrine, and held that “[s]ince 1993 . . . section A of Article 2.21 is the exclusive means for imposing liability on a corporation for the obligations of another corporation in which it holds shares,” actual fraud is required to be plead and proved in a veil piercing case based on a contract claim); *Menetti v. Chavers*, 974 S.W.2d 168, 174 (Tex. App.—San Antonio 1998) (the Court of Appeals reversed a judgment against defendant shareholders of a construction company in a faulty home construction case, holding that “the trial court erred in finding the [defendants] individually liable for the acts of their corporation[,] because there was legally insufficient evidence to show actual fraud,” and that, following the 1996 amendments to the TBCA, “the actual fraud requirement should be applied, by analogy, to tort claims, especially those arising from contractual obligations”); *Signal Peak Enter. of Texas, Inc. v. Bettina Inv., Inc.*, 138 S.W.3d 915, 925 (Tex. App.—Dallas 2004) (the court applied a two-step approach, first relying on *Castleberry* to establish that the corporation in question was merely the alter ego of its controlling shareholder, then finding that the defendant's conduct did not constitute actual fraud as required by TBCA art. 2.21: “Once alter ego is found to exist, the plaintiff must then show that the person on whom liability is sought to be imposed caused the corporation to be used for the purpose of perpetrating, and perpetrated an actual fraud on the obligee for the direct benefit of the person on whom liability is sought to be imposed.”); *Country Village Homes, Inc. v. Patterson*, 236 S.W.3d 413, 430 (Tex. App.—Houston [1st Dist.] 2007) (in a judgment later vacated by agreement, the court was willing to treat both the single business enterprise theory and the alter ego theory as viable paths to disregarding the corporate entity; the court then recognized that, after *Southern Union*, TBCA art. 2.21 controls all veil-piercing claims, and “that a finding of actual fraud is required in order to prove a theory of Single Business Enterprise”); and *Rutherford v. Atwood*, 2003 WL 22053687 (Tex. App.—Houston [1st Dist.] 2003) (the court (citing both *Menetti v. Chavers*, *supra*, and *Farr v. Sun World Sav. Ass'n*, 810 S.W.2d 294 (Tex. App.—El Paso 1991)) held that not only was a showing of actual fraud required in order to pierce the corporate veil, but that the fraud must (i) “relate to the transaction at issue” and (ii) be primarily for the defendant's direct personal benefit).

On November 14, 2008, *Castleberry* was explained and further limited by the Texas Supreme Court in *SSP Partners and Metro Novelties, Inc. v. Gladstrong Investments (USA) Corp.*²⁴⁰ As a result of the Texas Supreme Court's holding and teachings in *SSP*, *Castleberry* is no longer an authoritative statement of the Texas veil piercing common law. *SSP* was a products liability case in which a five-year-old boy was killed in a house fire started by a disposable butane lighter with a defective child-resistant mechanism sold by the defendant. In *SSP*, the Texas Supreme Court held that corporations cannot be held liable for each other's tort obligations merely because they are part of a single business enterprise.²⁴¹ *SSP* rejects the single business enterprise liability theory, and adopts the approach taken by the Legislature in TBCA article 2.21 as the embodiment of public policy in Texas. Additionally, because it was a pure products liability case, *SSP* should be interpreted as applying the public policy of TBCA article

²⁴⁰ 275 S.W.3d 444 (Tex. 2008).

²⁴¹ In explaining and limiting *Castleberry*, the Supreme Court in *SSP* wrote:

Abuse and injustice are not components of the single business enterprise theory The theory applies to corporations that engage in any sharing of names, offices, accounting, employees, services, and finances. There is nothing abusive or unjust about any of these practices in the abstract. Different entities may coordinate their activities without joint liability.

Creation of affiliated corporations to limit liability while pursuing common goals lies firmly within the law and is commonplace. We have never held corporations liable for each other's obligations merely because of centralized control, mutual purposes, and shared finances. There must also be evidence of abuse, or as we said in *Castleberry*, injustice and inequity. By "injustice" and "inequity" we do not mean a subjective perception of unfairness by an individual judge or juror; rather, these words are used in *Castleberry* as shorthand references for the kinds of abuse, specifically identified, that the corporate structure should not shield - fraud, evasion of existing obligations, circumvention of statutes, monopolization, criminal conduct, and the like. Such abuse is necessary before disregarding the existence of a corporation as a separate entity. Any other rule would seriously compromise what we have called a "bedrock principle of corporate law" that a legitimate purpose for forming a corporation is to limit individual liability for the corporation's obligations.

* * *

In *Castleberry*, we held that the corporate structure could be disregarded on a showing of constructive fraud, even without actual fraud. 721 S.W.2d at 273. The Legislature has since rejected that view in certain cases. Article 2.21 of the Texas Business Corporation Act takes a stricter approach to disregarding the corporate structure: [text of TBCA art. 2.21 omitted]

* * *

The single business enterprise liability theory is fundamentally inconsistent with the approach taken by the Legislature in Article 2.21.

Accordingly, we hold that the single business enterprise liability theory . . . will not support the imposition of one corporation's obligations on another.

(emphasis added). *SSP*, 275 S.W.3d at 454-456.

For additional authority for the proposition that TBCA art. 2.21 is the exclusive means for piercing the corporate veil of a Texas corporation and that actual fraud is a prerequisite thereunder, see Byron F. Egan and Curtis W. Huff, *Choice of State of Incorporation – Texas versus Delaware: Is It Now Time To Rethink Traditional Notions?*, 54 SMU L. REV. 249, 301-302 (Winter 2001); see also Alan R. Bromberg, Byron F. Egan, Dan L. Nicewander and Robert S. Trotti, *The Role of the Business Law Section and the Texas Business Law Foundation in the Development of Texas Business Law*, 41 TEX. J. BUS. L. 41, 64, 67 and 72 (Spring 2005); Alan R. Bromberg, Byron F. Egan, Dan L. Nicewander and Robert S. Trotti, *The Role of the Business Law Section and the Texas Business Law Foundation in the Development of Texas Business Law*, 31 BULL. OF BUS. L. SEC. OF THE ST. B. OF TEX. 1, 2, 19, 22 (June 1994).

2.21 to all tort cases, not just those arising out of contracts. *SSP* is now the definitive statement of the Texas law of veil piercing for all cases, whether arising out of contracts, torts or otherwise.²⁴²

Officers and other agents of a corporation are not covered by TBCA article 2.21 or TBOC § 21.223 because the various veil-piercing theories are applicable only to shareholders and have never been used by a Texas court to hold an officer as such liable for the obligations of the entity.²⁴³ There are causes of action for holding an officer personally liable for the officer's own wrongful conduct,²⁴⁴ for an individual is liable for his own torts although a corporation may assume the liability pursuant to an indemnification arrangement.²⁴⁵

Controlling shareholders can have liability for actions of a controlled corporation under federal and state securities laws,²⁴⁶ laws for the protection of the environment,²⁴⁷ employment laws²⁴⁸ and other federal and state statutes specific to the activities of the corporation.

²⁴² See *Tryco Enter., Inc. v. Robinson*, 390 S.W.3d 497 (Tex. App.—Houston [1st Dist.] 2012) *pet. dismissed*, No. 12-0866, 203 Tex. LEXIS 276 (April 5, 2013) (actual fraud found where controllers caused corporation to transfer its assets to an entity they owned to avoid paying a judgment and to forfeit its charter for failure to pay franchise taxes).

²⁴³ Directors and officers are personally liable to creditors under the Tex. Tax Code for debts of a corporation whose charter is forfeited for failure to pay franchise taxes if the debts were incurred after the date the report, tax or penalty was due and before the corporate privileges are reinstated. Tex. Tax Code section 171.255 provides in relevant part:

- (a) If the corporate privileges of a corporation are forfeited for the failure to . . . pay a tax or penalty, each director or officer of the corporation is liable for each debt of the corporation that is created or incurred in this state after the date on which the report, tax, or penalty is due and before the corporate privileges are revived. The liability includes liability for any tax or penalty imposed by this chapter on the corporation that becomes due and payable after the date of the forfeiture.
- (b) The liability of a director or officer is in the same manner and to the same extent as if the director or officer were a partner and the corporation were a partnership.
- (c) A director or officer is not liable for a debt of the corporation if the director or officer shows that the debt was created or incurred:
 - (1) over the director's objection; or
 - (2) without the director's knowledge and that the exercise of reasonable diligence to become acquainted with the affairs of the corporation would not have revealed the intention to create the debt.

Tex. Tax Code Ann. § 171.255 (Vernon 2012).

²⁴⁴ Civil Practice and Remedies Code § 98.0025 provides that a shareholder of a corporation or member of an LLC that is liable for human trafficking under § 98.002 (Liability) thereof, is jointly and severally liable with the entity to the person trafficked for damages arising from the illegal trafficking of that person (as defined in Texas Penal Code Chapter 20A) if the person demonstrates that the shareholder or member caused the entity to be used for the purpose of trafficking that person and did traffic that person for the direct personal benefit of the shareholder or member, notwithstanding any provision of the TBOC.

²⁴⁵ See TBOC §§ 8.001 et seq.

²⁴⁶ Securities Act of 1933 § 15, Securities Exchange Act of 1934 § 20, and Texas Securities Act §§ 33.F and 33-1.E; *cf. infra* notes 1399-1402, and related text.

²⁴⁷ See Byron F. Egan, Lindsay T. Boyd, Jon T. Hirschhoff, Stephen J. Humes, Cynthia Retallick, *Buyer Beware: Changing Laws on Environmental Liability for Successor Corporations*, Negotiated Acquisitions Committee Co-Sponsored Program, ABA 2004 Annual Meeting (Aug. 8, 2004).

2.5. Management. The corporation form of business entity allows for an efficient and flexible management structure. The traditional management structure of a corporation is centralized.²⁴⁹ Shareholders elect directors, who are given the power to manage the affairs of the corporation generally, as well as to formulate policies and objectives.²⁵⁰ Shareholders retain the power to vote on certain major matters.²⁵¹ Directors appoint officers, who are delegated the

²⁴⁸ See *Guipone v. BH S&B Holdings LLC, et al.*, 737 F.3d 221 (2d Cir. 2013) (hedge fund held liable under the Worker Adjustment Restraining and Notification Act (the “WARN Act”) for failure of controlled portfolio company to provide the requisite sixty days’ advance notice of mass layoffs or plant closings to employees).

²⁴⁹ Douglas K. Moll, *Shareholder Oppression & Reasonable Expectations: Of Change, Gifts, and Inheritances in Close Corporation Disputes*, 86 MINN. L. REV. 717, 724 (2002).

²⁵⁰ *Capital Bank v. Am. Eyewear, Inc.*, 597 S.W.2d 17, 20 (Tex. App.—Dallas 1980, no writ) (declaring that “the authority to manage a corporation’s affairs is vested in its board of directors.”). A Certificate of Formation may grant corporate directors different voting rights, whether or not elected by separate classes or series of shares. TBOC § 21.406(a) as amended in the 2009 Legislative Session by 2009 S.B. 1442 § 36.

²⁵¹ TBCA art. 2.28 and TBOC § 21.358 provide that the general requirement for a quorum of shareholders at a meeting of shareholders will be the holders of a majority of the outstanding shares entitled to vote at the meeting. This requirement may be increased or decreased to as few as one-third of the holders of the outstanding shares if so provided in the articles of incorporation or certificate of formation. Once there is a quorum of shareholders at a meeting of shareholders, there is a quorum for all matters to be acted upon at that meeting. Electronic meetings of shareholders are permitted by TBCA art. 2.24 if authorized in the articles of incorporation or bylaws. TBOC § 6.002 permits electronic meetings, subject to an entity’s governing documents.

The vote required for approval of certain matters varies depending on the matter requiring action. The vote required for the election of directors is a plurality of votes cast unless otherwise provided in the charter or bylaws of the corporation. TBCA art. 2.28; TBOC § 21.359. The vote required for approval of fundamental corporate transactions, such as charter amendments, mergers, and dissolutions, is the holders of at least two-thirds of the outstanding shares entitled to vote on the matter unless otherwise provided in the charter of the corporation. TBCA arts. 4.02A(3), 5.03E and 6.03A(3); TBOC § 21.364. The articles of incorporation or certificate of formation may increase this voting requirement, or reduce it to not less than the holders of a majority of the voting power entitled to vote on the matter. TBCA art. 2.28D; TBOC § 21.365(a).

Unless otherwise provided in the corporation’s articles of incorporation, certificate of formation, or bylaws, the general vote requirement for shareholder action on matters other than the election of directors and extraordinary transactions is a majority of the votes cast “for,” “against” or “expressly abstaining” on the matter. TBCA art. 2.28(B); TBOC § 21.363.

In corporations formed prior to September 1, 2003, unless expressly prohibited by the articles of incorporation, shareholders have the right to cumulate their votes in the election of directors if they notify the corporation at least one day before the meeting of their intent to do so; for corporations formed on or after September 1, 2003 and for those formed earlier but voluntarily opting in to the TBOC, shareholders do not have the right to cumulative voting unless the articles of incorporation or certificate of formation expressly grants that right. TBCA art. 2.29D; TBOC §§ 21.360, 21.362.

Each outstanding share is entitled to one vote unless otherwise provided in the corporation’s articles of incorporation or certificate of formation. TBCA art. 2.29(A)(1); TBOC § 21.366(a). Furthermore, unless divided into one or more series, shares of the same class are required to be identical. TBCA art. 2.12(A); TBOC § 21.152(c). Limitations on the voting rights of holders of the same class or series of shares are permitted, depending on the characteristics of the shares. TBCA art. 2.29(A)(2); TBOC § 21.153.

The voting of shares by proxy is permitted. TBCA art. 2.29; TBOC § 21.367(a). However, no proxy will be valid eleven months after execution unless otherwise provided in the proxy. TBOC § 21.368. Proxies may be made irrevocable if coupled with an interest and may be in the form of an electronic transmission. TBCA art. 2.29(C); TBOC §§ 21.367(b), 21.369(b).

authority to manage the corporation's day to day affairs and to implement the policies and objectives set by the directors.

Most corporate statutes, including the TBCA, the TBOC and the Delaware General Corporation Law (the "DGCL"), also provide for "close corporations" which may be managed by the shareholders directly.²⁵² A Texas corporation elects "close corporation" status by including a provision to such effect in its articles of incorporation or certificate of formation, and may provide in such document or in a shareholder agreement, which can be similar to a partnership agreement, that management will be by a board of directors or by the shareholders.²⁵³ Under the Tex. Corp. Stats., any Texas corporation (except a corporation whose shares are publicly traded) may modify how the corporation is to be managed and operated, in much the same way as a close corporation, by an agreement set forth in (1) the certificate of formation or the bylaws approved by all of the shareholders or (2) a written agreement signed by all of the shareholders.²⁵⁴ Thus, the management structure of corporations is generally flexible enough to

TBOC Chapter 3F, as added in the 2009 Legislative Session by 2009 S.B. 1442 § 4, provides that an entity's governing documents may provide for alternative governance processes in the event of a catastrophic event by which the entity's governing persons can act during the continuance of the emergency.

²⁵² See J. Leon Lebowitz, *Texas Close Corporation Law*, 44 TEX. B.J. 51 (1981); Robert W. Hamilton, *Corporations and Partnerships*, 36 SW. L.J. 227, 228-34 (1982).

²⁵³ TBCA arts. 12.11, 12.13, 12.31; TBOC §§ 3.008, 21.703, 21.713.

²⁵⁴ TBCA art. 2.30-1 and TBOC § 21.101 in effect extend close corporation flexibility to all corporations that are not publicly traded by authorizing shareholders' agreements that modify and override the mandatory provisions of the TBCA or the TBOC relating to operations and corporate governance. The agreement must be set forth in either (i) the articles of incorporation or bylaws and approved by all shareholders or (ii) in an agreement signed by all shareholders and made known to the corporation. TBCA art. 2.30-1(B)(1); TBOC § 21.101(b). The agreement is not required to be filed with the Secretary of State unless it is part of the articles of incorporation. TBCA arts. 2.30-1(B), 3.03; TBOC §§ 21.101(b), 4.002. An agreement so adopted may:

- (1) restrict the discretion or powers of the board of directors;
- (2) eliminate the board of directors and permit management of the business and affairs of the corporation by its shareholders, or in whole or in part by one or more of its shareholders, or by one or more persons not shareholders;
- (3) establish the natural persons who shall be the directors or officers of the corporation, their term of office or manner of selection or removal, or terms or conditions of employment of any director, officer, or other employee of the corporation, regardless of the length of employment;
- (4) govern the authorization or making of distributions, whether in proportion to ownership of shares, subject to the limitations in TBCA art. 2.38 (or TBOC § 21.303, as the case may be), or determine the manner in which profits and losses shall be apportioned;
- (5) govern, in general or in regard to specific matters, the exercise or division of voting power by and between the shareholders, directors (if any), or other persons or by or among any of them, including use of disproportionate voting rights or director proxies;
- (6) establish the terms and conditions of any agreement for the transfer or use of property or the provision of services between the corporation and any shareholder, director, officer or employee of the corporation, or other person or among any of them;
- (7) authorize arbitration or grant authority to any shareholder or other person as to any issue about which there is a deadlock among the directors, shareholders or other person or persons empowered to manage the corporation to resolve that issue;

allow both centralized management and decentralized management, depending on the needs of the corporation's owners.

2.6. Corporate Fiduciary Duties.

2.6.1. General Principles. The concepts that underlie the fiduciary duties of corporate directors have their origins in English common law of both trusts and agency from over two hundred years ago. The current concepts of those duties in both Texas and Delaware are still largely matters of evolving common law.²⁵⁵ Fiduciary duty principles articulated in the context of public companies are applicable to private companies in both Texas and Delaware, although the

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- (8) require dissolution of the corporation at the request of one or more of the shareholders or upon the occurrence of a specified event or contingency in which case the dissolution of the corporation shall proceed as if all the shareholders had consented in writing to dissolution of the corporation as provided in TBCA art. 6.02 or TBOC §§ 21.501-21.504; or
 - (9) otherwise govern the exercise of corporate powers or the management of the business and affairs of the corporation or the relationship among the shareholders, the directors and the corporation, or among any of them, as if the corporation were a partnership or in a manner that would otherwise be appropriate only among partners, and is not contrary to public policy.

TBCA art. 2.30-1(A); TBOC § 21.101(a). The existence of an art. 2.30-1 or TBOC § 21.101 agreement must be conspicuously noted on the certificates representing the shares or on the information statement required for uncertificated shares. TBCA art. 2.30-1(C); TBOC §§ 21.103(a), (b). A purchaser who acquires shares of a corporation without actual or deemed knowledge of the agreement will have a right of rescission until the earlier of (i) 90 days after obtaining such knowledge or (ii) two years after the purchase of the shares. TBCA art. 2.30-1(D); TBOC § 21.105. An agreement permitted under Article 2.30-1 or TBOC § 21.101 will cease to be effective when shares of the corporation become listed on a national securities exchange, quoted on an interdealer quotation system of a national securities association or regularly traded in a market maintained by one or more members of a national or affiliated securities association. TBCA art. 2.30-1(E); TBOC § 21.109.

An art. 2.30-1 or § 21.101 agreement that limits the discretion or powers of the board of directors or supplants the board of directors will relieve the directors of, and impose upon the person or persons in whom such discretion or powers or management of the business and affairs of the corporation are vested, liability for action or omissions imposed by the TBCA, the TBOC, or other law on directors to the extent that the discretion or powers of the directors are limited or supplanted by the agreement.

Art. 2.30-1(G) and TBOC § 21.107 provide that the existence or performance of an art. 2.30-1 or § 21.101 agreement will not be grounds for imposing personal liability on any shareholder for the acts or obligations of the corporation by disregarding the separate entity of the corporation or otherwise, even if the agreement or its performance (i) treats the corporation as if it were a partnership or in a manner that otherwise is appropriate only among partners, (ii) results in the corporation being considered a partnership for purposes of taxation, or (iii) results in failure to observe the corporate formalities otherwise applicable to the matters governed by the agreement. Thus, TBCA art. 2.30-1 and TBOC § 21.107 provide protection beyond TBCA art. 2.21 and TBOC § 21.223 on shareholder liability.

²⁵⁵ The “fiduciary duties of corporate officers and directors . . . are creatures of state common law[.]” *Gearhart Indus., Inc. v. Smith Int’l, Inc.*, 741 F.2d 707, 719 (5th Cir. 1984) (citing *Cohen v. Beneficial Indus. Loan Corp.*, 337 U.S. 541, 549 (1949)); *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 697 (Del. Ch. 2005) (“Unlike ideals of corporate governance, a fiduciary’s duties do not change over time”), *aff’d*, 906 A.2d 27 (Del. 2006); *see also Burks v. Lasker*, 441 U.S. 471, 477 (1979). Federal courts generally apply applicable state common law in fiduciary duty cases. *See e.g. Floyd v. Hefner*, No. H-03-5693, 2006 WL 2844245, at *4 (S.D. Tex. Sept. 29, 2006).

application of those principles is contextual and the corporate process required to comply with those principles can vary depending on the circumstances.²⁵⁶

Both the Tex. Corp. Stats. and the Delaware General Corporation Law (as amended, the “DGCL”)²⁵⁷ provide that the business and affairs of a corporation are to be managed under the direction of its board of directors (“Board”).²⁵⁸ While the Tex. Corp. Stats. and the DGCL provide statutory guidance as to matters such as the issuance of securities, the payment of dividends, the notice and voting procedures for meetings of directors and shareholders, and the ability of directors to rely on specified persons and information, the nature of a director’s “fiduciary” duty to the corporation and the shareholders has been largely defined by the courts through damage and injunctive actions.²⁵⁹ In Texas, the fiduciary duty of a director has been

²⁵⁶ Under TBOC § 21.363(a) a corporation is “closely held” if it has fewer than 35 shareholders and its stock is not publicly traded. *See Ritchie v. Rupe*, 443 S.W.3d 856, 860-63 (Tex. 2014) (in the context of discussing the role of “the honest exercise of business judgment and discretion” by a Board in determining whether a receivership is an appropriate remedy in a shareholder oppression case, the Texas Supreme Court wrote that Texas law “does not distinguish between closely held and other types of corporations.”). *See infra* notes 901-986 regarding oppression of minority shareholders in the context of closely held entities.

²⁵⁷ 8 DEL. CODE ANN. § 101 *et seq.* (Supp. 2015).

²⁵⁸ TBOC § 21.401; TBCA art. 2.31; and DGCL § 141(a); *CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227, 238 (Del. 2008) (Board authority to manage the corporation under DGCL § 141(a) may not be infringed by a bylaw adopted by the stockholders under DGCL § 109 in a manner that restricts the power of directors to exercise their fiduciary duties); *see supra* notes 164-165 and related text.

²⁵⁹ Although the DGCL “does not prescribe in detail formal requirements for board meetings, the meetings do have to take place [and] the mere fact that directors are gathered together does not a meeting make”; where there is no formal call to the meeting and no vote taken, directors caucusing on their own and informally deciding among themselves how they would proceed is like simply polling board members and “does not constitute a valid meeting or effective corporate action.” *Fogel v. U.S. Energy Sys. Inc.*, No. 3271-CC, 2007 WL 4438978 at *2 (Del. Ch. 2007) (citations omitted), *rejected on other grounds by Klassen v. Allegro Dev. Corp.*, 106 A.3d 1035, 1047 (Del. 2014).

The *Fogel* case arose in the context of a confrontation between three independent directors and the Board chairman they sought to terminate (there were no other directors). The opinion by Chancellor William B. Chandler III recounted that U.S. Energy “was in precarious financial condition” when Fogel was hired in 2005 to become both CEO and a director (ultimately, becoming Board chairman as well). *Id.* at *1. Fogel’s initial tenure with the company was successful, but trouble soon followed.

Upon learning of the entity’s financial woes, the Board decided at a June 14, 2006 meeting to hire a financial adviser or restructuring official. The Board resolved to meet again on June 29 to interview potential candidates, but prior to that meeting, the three independent directors communicated with one another about Fogel’s performance, ultimately deciding that he would have to be terminated.

On the morning of June 29, the three directors met in the law offices of their outside counsel and decided to fire Fogel. They then confronted Fogel in the boardroom where the meeting was to take place, advised that they had lost faith in him, and stated that they wanted him to resign as chairman and CEO. Fogel challenged the directors’ ability to fire him and ultimately refused to resign, whereupon an independent director informed him that he was terminated. Thereafter, on July 1, Fogel e-mailed the company’s general counsel and the Board, calling for a special shareholder meeting for the purpose of voting on the removal of the other directors and electing their replacements. Later that day, during a scheduled Board meeting, the Board formally passed a resolution terminating Fogel and thereafter ignored Fogel’s call for a special meeting. Litigation ensued.

The issue in the case was whether Fogel was still CEO and Board chairman at the time he called for a special meeting of shareholders. If the independent directors’ June 29 decision to fire Fogel constituted formal Board action, Fogel was terminated before July 1 and lacked authority to call for a special meeting

characterized as including duties of loyalty (including good faith), care and obedience.²⁶⁰ In Delaware, the fiduciary duties include those of loyalty (including good faith) and care.²⁶¹ Importantly, the duty of loyalty gives rise to an important corollary fiduciary precept – namely, the so-called “duty of disclosure,” which requires the directors to disclose full and accurate information when communicating with stockholders.²⁶² The term “duty of disclosure,” however, is somewhat of a misnomer because no separate duty of disclosure actually exists. Rather, as

of shareholders. If not, Fogel remained Board chairman and CEO until the July 1 formal resolution, which passed after Fogel called for the special meeting of shareholders.

The Court noted that under DGCL § 141 termination of the chairman and CEO required Board “action, and the board can only take action by means of a vote at a properly constituted meeting. * * * Although the [DGCL] does not prescribe in detail formal requirements for board meetings, the meetings do have to take place.” *Id.* at *2. In this case, the Chancellor concluded that the June 29 confrontation between Fogel and the independent directors did not constitute a meeting. The mere fact that directors were gathered and caucusing did not constitute a meeting as there was no formal call to the meeting and there was no vote whatsoever.

“Simply ‘polling board members does not constitute a valid meeting or effective corporation action,’” the Chancellor instructed. *Id.* at *2. In any event, the Court added, if the meeting did occur, it would be void because the independent directors—who kept secret their plan to fire Fogel—obtained Fogel’s attendance by deception. Although Fogel lacked the votes needed to protect his employment, the Chancellor reasoned that had he known of the defendants’ plans beforehand, “he could have exercised his right under the bylaws to call for a special meeting before the board met. The deception renders the meeting and any action taken there void.” *Id.* at *4. Accordingly, Fogel was still authorized on July 1 to call for a special shareholder meeting, and corporation and its Board were ordered to hold such a meeting.

The Chancellor disagreed with the independent directors’ argument that, even if the June 29 meeting and termination were deficient, “any problems were cured” when the Board ratified its June 29 actions during the July 1 meeting, and explained: “When a corporate action is void, it is invalid *ab initio* and cannot be ratified later.” *Id.* The Chancellor said the action taken at the July 1 meeting may have resulted in Fogel’s termination, but the termination was effective only as of that vote. By that time, however, Fogel already had issued his call for a special shareholders’ meeting.

Nonetheless, the Court concluded that the independent directors ignoring Fogel’s call for a special meeting was not to thwart a shareholder vote, but because they “believed in good faith” that Fogel had been terminated and thus “lacked the authority to call for such a meeting.” *Id.* Accordingly, the Chancellor held that the three independent directors did not breach their fiduciary obligations of loyalty. *But see Klassen v. Allegro Dev. Corp.*, 106 A.3d 1035, 1047 (Del. 2013) (holding that Board action by deception is voidable, not void *ab initio*).

²⁶⁰ *Gearhart Indus., Inc.*, 741 F.2d at 719.

²⁶¹ While good faith was once “described colloquially as part of a ‘triad’ of fiduciary duties that includes the duties of care and loyalty,” the Delaware Supreme Court in 2006 clarified the relationship of “good faith” to the duties of care and loyalty, explaining:

[T]he obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty. Only the latter two duties, where violated, may directly result in liability, whereas a failure to act in good faith may do so, but indirectly. The second doctrinal consequence is that the fiduciary duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest. It also encompasses cases where the fiduciary fails to act in good faith.

²⁶² *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006). See *infra* notes 317-426, 633-666 and related text.

“Once [directors] traveled down the road of partial disclosure . . . an obligation to provide the stockholders with an accurate, full, and fair characterization” attaches. *Arnold v. Soc’y for Sav. Bancorp, Inc.*, 650 A.2d 1270, 1280 (Del. 1994); see also *In re MONY Group S’holders Litig.*, 852 A.2d 9, 24-25 (Del. Ch. 2004) (“[O]nce [directors] take it upon themselves to disclose information, that information must not be misleading.”).

indicated, the fiduciary obligations of directors with respect to the disclosures involve a contextually-specific application of the duty of loyalty.²⁶³

2.6.2. Applicable Law; Internal Affairs Doctrine. “The internal affairs doctrine is a conflict of laws principle which recognizes that only one State should have the authority to regulate a corporation’s internal affairs,”²⁶⁴ and “under the commerce clause a state has no interest in regulating the internal affairs of foreign corporations.”²⁶⁵ “Internal corporate affairs” are “those matters which are peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders,”²⁶⁶ and are to be distinguished from matters which are not unique to corporations:

It is essential to distinguish between acts which can be performed by both corporations and individuals, and those activities which are peculiar to the corporate entity. Corporations and individuals alike enter into contracts, commit torts, and deal in personal and real property. Choice of law decisions relating to such corporate activities are usually determined after consideration of the facts of each transaction. The internal affairs doctrine has no applicability in these situations.²⁶⁷

The internal affairs doctrine in Texas mandates that courts apply the law of a corporation’s state of incorporation in adjudications regarding director fiduciary duties.²⁶⁸ Delaware also subscribes to the internal affairs doctrine.²⁶⁹

²⁶³ *Malone v. Brincat*, 722 A.2d 5, 10 (Del. 1998) (“[W]hen directors communicate with stockholders, they must recognize their duty of loyalty to do so with honesty and fairness”); see *infra* notes 645-647 and related text.

²⁶⁴ *Edgar v. MITE Corp.*, 457 U.S. 624, 645 (1982).

²⁶⁵ *McDermott, Inc. v. Lewis*, 531 A.2d 206, 217 (Del. 1987) (internal quotations omitted); Frederick Tung, *Before Competition: Origins of the Internal Affairs Doctrine*, 32 J. CORP. L. 33, 39 (Fall 2006).

²⁶⁶ *Edgar*, 457 U.S. at 645.

²⁶⁷ *McDermott*, 531 A.2d at 215 (citing *Edgar*, 457 U.S. at 645).

²⁶⁸ TBOC §§ 1.101-1.105; TBCA, art. 8.02; TMCLA art. 1302-1.03; *Hollis v. Hill*, 232 F.3d 460, 465 (5th Cir. 2000); *Gearhart Indus., Inc. v. Smith Int’l, Inc.*, 741 F.2d 707, 719 (5th Cir. 1984); *A. Copeland Enters., Inc. v. Guste*, 706 F. Supp. 1283, 1288 (W.D. Tex. 1989).

²⁶⁹ See *VantagePoint Venture Partners 1996 v. Examen, Inc.*, 871 A.2d 1108, 1112 (Del. 2005) (considering whether a class of preferred stock would be entitled to vote as a separate class on the approval of a merger agreement and ruled that Delaware law, rather than California law, governed and did not require the approval of the holders of the preferred stock voting separately as a class for approval of the merger. In reaching that conclusion, the Court held that the DGCL exclusively governs the internal corporate affairs of a Delaware corporation and that Section 2115 of the California Corporations Code, which requires a corporation with significant California contacts (sometimes referred to as a “quasi-California corporation”) to comply with certain provisions of the California Corporations Code even if the corporation is incorporated in another state, such as Delaware, is unconstitutional and, as a result of Delaware rather than California law governing, the approval of the merger did not require the approval of the holders of the preferred stock voting separately as a class). See *infra* notes 478-488 and related text.

The California courts, however, tend to uphold California statutes against internal affairs doctrine challenges. See *Friese v. Superior Court of San Diego County*, 36 Cal. Rptr. 3d 558 (Cal. Ct. App. 2005), in which a California court allowed insider trading claims to be brought against a director of a California based Delaware corporation and wrote “while we agree that the duties officers and directors owe a

The DGCL subjects directors and officers of Delaware corporations to personal jurisdiction in the Delaware Court of Chancery over claims for violation of a duty in their capacities as directors or officers of Delaware corporations.²⁷⁰ Texas does not have a comparable statute.

corporation are in the first instance defined by the law of the state of incorporation, such duties are not the subject of California's corporate securities laws in general or [Corporate Securities Law] section 25502.5 in particular Because a substantial portion of California's marketplace includes transactions involving securities issued by foreign corporations, the corporate securities laws have been consistently applied to such transactions."

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10 *Del. C.* § 3114(a) and (b) provide (emphasis added):

(a) Every nonresident of this State who after September 1, 1977, accepts election or appointment as a director, trustee or member of the governing body of a corporation organized under the laws of this State or who after June 30, 1978, serves in such capacity, and every resident of this State who so accepts election or appointment or serves in such capacity and thereafter removes residence from this State shall, by such acceptance or by such service, be deemed thereby to have consented to the appointment of the registered agent of such corporation (or, if there is none, the Secretary of State) as an agent upon whom service of process may be made in all civil actions or proceedings brought in this State, by or on behalf of, or against such corporation, in which such director, trustee or member is a necessary or proper party, or in any action or proceeding against such director, trustee or member *for violation of a duty in such capacity*, whether or not the person continues to serve as such director, trustee or member at the time suit is commenced. Such acceptance or service as such director, trustee or member shall be a signification of the consent of such director, trustee or member that any process when so served shall be of the same legal force and validity as if served upon such director, trustee or member within this State and such appointment of the registered agent (or, if there is none, the Secretary of State) shall be irrevocable.

(b) Every nonresident of this State who after January 1, 2004, accepts election or appointment as an officer of a corporation organized under the laws of this State, or who after such date serves in such capacity, and every resident of this State who so accepts election or appointment or serves in such capacity and thereafter removes residence from this State shall, by such acceptance or by such service, be deemed thereby to have consented to the appointment of the registered agent of such corporation (or, if there is none, the Secretary of State) as an agent upon whom service of process may be made in all civil actions or proceedings brought in this State, by or on behalf of, or against such corporation, in which such officer is a necessary or proper party, or in any action or proceeding against such officer *for violation of a duty in such capacity*, whether or not the person continues to serve as such officer at the time suit is commenced. Such acceptance or service as such officer shall be a signification of the consent of such officer that any process when so served shall be of the same legal force and validity as if served upon such officer within this State and such appointment of the registered agent (or, if there is none, the Secretary of State) shall be irrevocable. As used in this section, the word "officer" means an officer of the corporation who (i) is or was the president, chief executive officer, chief operating officer, chief financial officer, chief legal officer, controller, treasurer or chief accounting officer of the corporation at any time during the course of conduct alleged in the action or proceeding to be wrongful, (ii) is or was identified in the corporation's public filings with the United States Securities and Exchange Commission because such person is or was 1 of the most highly compensated executive officers of the corporation at any time during the course of conduct alleged in the action or proceeding to be wrongful, or (iii) has, by written agreement with the corporation, consented to be identified as an officer for purposes of this section.

2.6.3. Fiduciary Duties in Texas Cases. Texas has its own body of precedent with respect to director fiduciary duties. In *Gearhart Industries, Inc. v. Smith International*, the Fifth Circuit sharply criticized the parties’ arguments based on Delaware cases and failure to cite Texas jurisprudence in their briefing on director fiduciary duties:

We are both surprised and inconvenienced by the circumstances that, despite their multitudinous and voluminous briefs and exhibits, neither plaintiffs nor defendants seriously attempt to analyze officers’ and directors’ fiduciary duties or the business judgment rule under *Texas* law. This is a particularity so in view of the authorities cited in their discussions of the business judgment rule: Smith and Gearhart argue back and forth over the applicability of the plethora of out-of-state cases they cite, yet they ignore the fact that we are obligated to decide these aspects of this case under Texas law.²⁷¹

The Fifth Circuit stated in *Gearhart* that under Texas law “[t]hree broad duties stem from the fiduciary status of corporate directors; namely the duties of obedience, loyalty, and due care,” and commented that (i) the duty of obedience requires a director to avoid committing *ultra vires* acts, i.e., acts beyond the scope of the authority of the corporation as defined by its articles of incorporation or the laws of the state of incorporation, (ii) the duty of loyalty dictates that a director must act in good faith and must not allow his personal interests to prevail over the interests of the corporation, and (iii) the duty of due care requires that a director must handle his corporate duties with such care as an ordinarily prudent man would use under similar circumstances.²⁷² Good faith under *Gearhart* is an element of the duty of loyalty. *Gearhart* remains the seminal case for defining the fiduciary duties of directors in Texas. Many Texas fiduciary duty cases arise in the context of closely held corporations.²⁷³

The Texas Supreme Court’s June 20, 2014 opinion in *Ritchie v. Rupe*²⁷⁴ is most often cited for its holding that for claims of “minority shareholder oppression” – essentially, acts of a majority shareholder group that are harmful to a minority shareholder without necessarily harming the corporation itself²⁷⁵ – the sole remedy available under Texas law is a statutory receivership, but the opinion is equally important for its holding that common law fiduciary duties, as articulated in *Gearhart*, are still the appropriate lens through which to evaluate the

²⁷¹ *Gearhart Indus., Inc. v. Smith Int’l*, 741 F.2d 707, 719 n.4 (5th Cir. 1984).

²⁷² *Id.* at 719-21; *McCullum v. Dollar*, 213 S.W. 259, 260 (Tex. Comm’n App. 1919, holding approved); *see Landon v. S & H Mktg. Group, Inc.*, 82 S.W.3d 666, 672 (Tex. App.—Eastland 2002, no pet.) (quoting and repeating the summary of Texas fiduciary duty principles from *Gearhart*).

²⁷³ *See generally Flanary v. Mills*, 150 S.W.3d 785, 794-96 (Tex. App.—Austin 2004, pet. denied) (examining situation where uncle and nephew incorporated 50%/50% owned roofing business, but never issued stock certificates or had board or shareholder meetings; uncle used corporation’s banking account as his own, told nephew business doing poorly and sent check to nephew for \$7,500 as his share of proceeds of business for four years; the Court held uncle liable for breach of fiduciary duties that we would label loyalty and candor.)

²⁷⁴ 443 S.W.3d 856, 860 (Tex. 2014). *See Landon v. S & H Mktg. Group, Inc.*, 82 S.W.3d 666, 672 (Tex. App.—Eastland 2002, no pet.) (quoting and repeating the summary of Texas fiduciary duty principles from *Gearhart*).

²⁷⁵ *See infra* notes 899-982 regarding oppression of minority shareholders in the context of closely held entities.

conduct of directors of Texas corporations. The Supreme Court in *Ritchie v. Rupe* explained that the robustness of those fiduciary duty claims was one of its reasons for holding that in Texas there is not separate cause of action of shareholder oppression, and cited *Gearhart* as authoritative for its description of the common law fiduciary duties that directors owe the corporations they serve by virtue of being a director:

Directors, or those acting as directors, owe a fiduciary duty to the corporation in their directorial actions, and this duty “includes the dedication of [their] uncorrupted business judgment for the sole benefit of the corporation.” *Int’l Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 577 (Tex. 1963); *see also Gearhart Indus., Inc. v. Smith Intern., Inc.*, 741 F.2d 707, 723-24 (5th Cir. 1984) (describing corporate director’s fiduciary duties of obedience, loyalty, and due care).²⁷⁶

(a) Loyalty.

(1) Good Faith. The duty of loyalty in Texas is a duty that dictates that the director act in good faith and not allow his personal interest to prevail over that of the corporation.²⁷⁷ Whether there exists a personal interest by the director will be a question of fact.²⁷⁸ The good faith of a director will be determined on whether the director acted with an intent to confer a benefit to the corporation.²⁷⁹ In Texas “good faith” has been held to mean “[a] state of mind consisting in (1) honesty of belief or purpose, (2) faithfulness to one’s duty or obligation, ... or (4) absence of intent to defraud or to seek unconscionable advantage.”²⁸⁰

(2) Self-Dealing Transactions. In general, a director will not be permitted to derive a personal profit or advantage at the expense of the corporation and must act solely with an eye to the best interest of the corporation, unhampered by any pecuniary interest of his own.²⁸¹ The Court in *Gearhart* summarized Texas law with respect to the question of whether a director is “interested” in the context of self-dealing transactions:

A director is considered “interested” if he or she (1) makes a personal profit from a transaction by dealing with the corporation or usurps a corporate opportunity . . . ; (2) buys or sells assets of the corporation . . . ; (3) transacts business in his director’s capacity with a second corporation of which he is also a director or

²⁷⁶ 443 S.W.3d at 868.

²⁷⁷ *Gearhart*, 741 F.2d at 719.

²⁷⁸ *Int’l Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 578 (Tex. 1963).

²⁷⁹ *Int’l Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 577 (Tex. 1963) (indicating that good faith conduct requires a showing that the directors had “an intent to confer a benefit to the corporation”).

²⁸⁰ *Johnson v. Jackson Walker, L.L.P.*, 247 S.W.3d 765, 772 (Tex. App.—Dallas 2008), quoting from BLACK’S LAW DICTIONARY 701 (7th ed. 1999).

²⁸¹ *A. Copeland Enters. Inc. v. Guste*, 706 F. Supp. 1283, 1291 (W.D. Tex. 1989); *Milam v. Cooper Co.*, 258 S.W.2d 953 (Tex. Civ. App.—Waco 1953, writ ref’d n.r.e.); *see Kendrick, The Interested Director in Texas*, 21 Sw. L.J. 794 (1967).

significantly financially associated . . . ; or (4) transacts business in his director's capacity with a family member.²⁸²

In *Ritchie v. Rupe*,²⁸³ the Supreme Court elaborated that:

[T]he duty of loyalty that officers and directors owe to the corporation specifically prohibits them from misapplying corporate assets for their personal gain or wrongfully diverting corporate opportunities to themselves. Like most of the actions we have already discussed, these types of actions may be redressed through a derivative action, or through a direct action brought by the corporation, for breach of fiduciary duty.

Texas courts also hold that a fiduciary owes to its principal a strict duty of “good faith and candor,”²⁸⁴ including full disclosure respecting matters affecting the principal's interests.²⁸⁵ There is a “general prohibition against the fiduciary using his relationship with the corporation to benefit his personal interest.”²⁸⁶

The Tex. Corp. Stats. permit a corporation to renounce any interest in business opportunities presented to the corporation or one or more of its officers, directors or shareholders in its certificate of formation or by action of its board of directors.²⁸⁷

(3) **Oversight.** In Texas, an absence of good faith may also be found in situations where there is a severe failure of director oversight. In *FDIC v. Harrington*,²⁸⁸ a Federal District Court applying Texas law held that there is an absence of good faith when a board “abdicates [its] responsibilities and fails to exercise any judgment.”

(4) **Business Opportunities.** The “corporate opportunity doctrine,” also called the “business opportunity doctrine,” deals with when a fiduciary of a corporation may take personal advantage of a business opportunity that arguably “belongs” to the corporation. It arises out of the fiduciary duty of loyalty, which generally provides that a director or officer of a corporation may not place his individual interests over the interests of the corporation or its stockholders. Corporate opportunity claims often are instances in which officers or directors use for their personal advantage information obtained in their corporate capacity, and arise where the fiduciary and the corporation compete against each other to buy something, whether it be a

²⁸² *Gearhart*, 741 F.2d at 719-20 (citations omitted); see *Landon v. S & H Mktg. Group, Inc.*, 82 S.W.3d 666, 672 (Tex. App.—Eastland 2002, no pet.) (citing and repeating the “independence” test articulated in *Gearhart*). See also *infra* notes 562-570 and related text.

²⁸³ 443 S.W.3d at 887.

²⁸⁴ See *infra* notes 295-296 and related text.

²⁸⁵ *Icom Systems, Inc. v. Davies*, 990 S.W.2d 408, 410 (Tex. App.—Texarkana 1999, no pet.).

²⁸⁶ *NRC, INC. d/b/a National Realty v. Richard Huddleston*, 886 S.W.2d 526, 530 (Tex. App.—Austin 1994, no writ), citing *Chien v. Chen*, 759 S.W.2d 484, 495 (Tex. App.—Austin 1988, no writ).

²⁸⁷ TBCA art. 2.02(20), TBOC § 2.101(21); see *infra* note 560 and related text.

²⁸⁸ 844 F. Supp. 300, 306 (N.D. Tex. 1994).

patent, license, or an entire business.²⁸⁹ The central question is whether or not the director has appropriated something for himself that, in all fairness, should belong to his corporation.²⁹⁰

*Landon v. S & H Marketing Group, Inc.*²⁹¹ summarizes the Texas law on usurpation of corporate opportunities as follows:

To establish a breach of fiduciary duty by usurping a corporate opportunity, the corporation must prove that an officer or director misappropriated a business opportunity that properly belongs to the corporation. *International Bankers Life Insurance Company v. Holloway*, supra at 576-78; *Icom Systems, Inc. v. Davies*, 990 S.W.2d 408, 410 (Tex. App.—Texarkana 1999, no writ). The business opportunity arises where a corporation has a legitimate interest or expectancy in and the financial resources to take advantage of a particular business opportunity. * * * A corporation's financial inability to take advantage of a corporate opportunity is one of the defenses which may be asserted in a suit involving an alleged appropriation of a corporate opportunity. * * * A corporation's abandonment of a business opportunity is another defense to a suit alleging usurpation of a corporate opportunity. * * * The burden of pleading and proving corporate abandonment and corporate inability is placed upon the officer or director who allegedly appropriated the corporate opportunity. * * *

Texas recognizes that a fiduciary may independently generate an opportunity in which his principal has no ownership expectations.²⁹² The duty of candor, however, may not allow a director to unilaterally determine that a business opportunity would not be pursued by his corporation and may require that the opportunity be presented formally to the corporation's Board for its determination.²⁹³ The burden of pleading and proving that the corporation was unable to take advantage of the opportunity is on the director or officer who allegedly appropriated the opportunity.²⁹⁴ However, a finding that the corporation would not have exercised the opportunity at issue under the same terms and conditions as the officer or director is immaterial. A fiduciary cannot escape the duty to disclose an opportunity presented by securing an after-the-fact finding that the corporation was unable to take advantage of or would have rejected the business opportunity seized by the fiduciary had it been offered. When an officer or director usurps a corporate opportunity, he has breached the fiduciary duty of loyalty.

TBOC § 2.101(21) permits a corporation to renounce, in its certificate of formation or by action of its Board, any interest or expectancy of the corporation in specified business opportunities, or a specified class thereof, presented to the corporation or one or more of its officers, directors or shareholders. Since TBOC § 2.101(21) does not appear to authorize blanket

²⁸⁹ *Thorpe v. CERBCO, Inc.*, 676 A.2d 436 (Del. 1996).

²⁹⁰ *Equity Corp. v. Milton*, 221 A.2d 494, 497 (Del. 1966).

²⁹¹ 82 S.W.3d 666, 672 (Tex. App.—Eastland 2002, no pet.).

²⁹² *Scruggs Management Appellant Services, Inc. v. Hanson*, 2006 WL 3438243, at *1 (Tex. App.—Fort Worth, Nov. 30, 2006, pet. denied).

²⁹³ *Imperial Group (Texas), Inc. v. Scholnick*, 709 S.W.2d 358, 363 (Tex. App.—Tyler 1986, writ ref'd n.r.e.); *Icom Systems, Inc. v. Davies*, 990 S.W.2d 408, 410 (Tex. App.—Texarkana 1999, no pet.).

²⁹⁴ *Landon v. S & H Marketing Group, Inc.*, 82 S.W.3d 666, 673 (Tex. App.—Eastland 2002, no pet.).

renunciations of all business opportunities, a boilerplate renunciation may be less protective than one tailored to each situation. Further, although TBOC § 2.101(21) allows a corporation to specifically forgo individual corporate opportunities or classes of opportunities, the level of judicial scrutiny applied to the decision to make any such renunciation of corporate opportunities will generally be governed by a traditional common law fiduciary duty analysis, which means that a Board decision to renounce corporate opportunities should be made by informed and disinterested directors.

(5) Candor. In Texas the duty of loyalty includes a fiduciary duty of candor when communicating with shareholders. Texas courts also hold that a fiduciary owes to its principal a strict duty of “good faith and candor,” including full disclosure respecting matters affecting the principal’s interests.²⁹⁵ The duty of candor applies when a director is communicating with the corporation regarding a business opportunity.²⁹⁶

(b) Care.

(1) Business Judgment Rule; Gross Negligence. The duty of care in Texas requires the director to handle his duties with such care as an ordinarily prudent man would use under similar circumstances. In performing this obligation, the director must be diligent and informed and exercise honest and unbiased business judgment in pursuit of corporate interests.²⁹⁷

In general, the duty of care will be satisfied if the director’s actions comport with the standard of the business judgment rule. In *Sneed v. Webre*,²⁹⁸ which involved the application of the business judgment rule to a shareholder derivative suit on behalf of a closely held Texas corporation with fewer than 35 shareholders, the Texas Supreme Court on May 29, 2015 held: “The business judgment rule in Texas generally protects corporate officers and directors, who owe fiduciary duties to the corporation, from liability for acts that are within the honest exercise of their business judgment and discretion.” Following *Ritchie v. Rupe*²⁹⁹ the year before and the Fifth Circuit in *Gearhart*,³⁰⁰ the Texas Supreme Court in *Sneed v. Webre* cited and quoted from the early Texas decision of *Cates v. Sparkman*³⁰¹ as setting the standard for judicial intervention in cases involving duty of care issues:

In Texas, the business judgment rule protects corporate officers and directors from being held liable to the corporation for alleged breach of duties based on actions that are negligent, unwise, inexpedient, or imprudent if the actions were “within the exercise of their discretion and judgment in the development or prosecution of the enterprise in which their interests are involved.” *Cates*, 11 S.W. at 849. “Directors, or those acting as directors, owe a

²⁹⁵ *Icom Systems, Inc. v. Davies*, 990 S.W.2d 408, 410 (Tex. App.—Texarkana 1999, no pet.).

²⁹⁶ See *supra* note 293 and related text.

²⁹⁷ *Gearhart*, 741 F.2d at 719; *McCullum v. Dollar*, 213 S.W. 259, 260 (Tex. Comm’n App. 1919, holding approved).

²⁹⁸ 465 S.W.3d at 178.

²⁹⁹ *Ritchie v. Rupe*, 443 S.W.3d 856 (Tex. 2014).

³⁰⁰ *Gearhart Indus., Inc. v. Smith Int’l, Inc.*, 741 F.2d 707 (5th Cir. 1984)

³⁰¹ *Cates v. Sparkman*, 11 S.W. 846, 849 (Tex. 1889).

fiduciary duty to the corporation in their directorial actions, and this duty ‘includes the dedication of [their] uncorrupted business judgment for the sole benefit of the corporation.’” *Ritchie*, 443 S.W.3d at 868 (quoting *Int’l Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 577 (Tex. 1963)). The business judgment rule also applies to protect the board of directors’ decision to pursue or forgo corporate causes of action.³⁰²

In *Gearhart* the Court commented that, in spite of the requirement that a corporate director handle his duties with such care as an ordinarily prudent man would use under similar circumstances, Texas courts will not impose liability upon a *noninterested* corporate director unless the challenged action is *ultra vires* or is tainted by fraud. In a footnote in the *Gearhart* decision, the Fifth Circuit stated:

The business judgment rule is a defense to the duty of care. As such, the Texas business judgment rule precludes judicial interference with the business judgment of directors absent a showing of fraud or an *ultra vires* act. If such a showing is not made, then the good or bad faith of the directors is irrelevant.³⁰³

The Fifth Circuit further explained that “[e]ven though *Cates* was decided in 1889, and despite the ordinary care standard announced in *McCollum v. Dollar*, [213 S.W. 259, 260 (Tex. Comm’n App. 1919, holding approved)], Texas courts to this day will not impose liability upon a noninterested corporate director unless the challenged action is *ultra vires* or is tainted by fraud.”³⁰⁴

None of *Sneed v. Webre*, *Ritchie v. Rupe*, *Gearhart* nor the earlier Texas cases on which they relied referenced “gross negligence” as a standard for director liability. The business judgment rule as articulated in these cases protects grossly negligent conduct. Earlier Federal District Court decisions in the context of lawsuits by the Federal Deposit Insurance Corporation (“*FDIC*”) and the Resolution Trust Company (“*RTC*”) arising out of failed financial institutions, declined to interpret Texas law this broadly and held that the Texas business judgment rule does not protect “any breach of the duty of care that amounts to gross negligence” or “directors who abdicate their responsibilities and fail to exercise any judgment.”³⁰⁵ These decisions, however, “appear to be the product of the special treatment banks may receive under Texas law” and likely

³⁰² 465 S.W.3d at 178.

³⁰³ *Gearhart*, 741 F.2d at 723 n.9.

³⁰⁴ *Gearhart*, 741 F.2d at 721.

³⁰⁵ *FDIC v. Harrington*, 844 F. Supp. 300, 306 (N.D. Tex. 1994); *see also* *FDIC v. Schreiner*, 892 F. Supp. 869, 882 (W.D. Tex. 1995); *FDIC v. Benson*, 867 F. Supp. 512, 522 (S.D. Tex. 1994); *RTC v. Acton*, 844 F. Supp. 307, 314 (N.D. Tex. 1994); *RTC v. Norris*, 830 F. Supp. 351, 357-58 (S.D. Tex. 1993); *FDIC v. Brown*, 812 F. Supp. 722, 726 (S.D. Tex. 1992); *cf.* *RTC v. Miramon*, 22 F.3d 1357, 1360 (5th Cir. 1994) (following *Harrington* analysis of § 1821(K) of the Financial Institutions Reform, Recovery and Enforcement Act (“*FIRREA*”) which held that federal common law of director liability did not survive *FIRREA* and applied Texas’ gross negligence standard for financial institution director liability cases under *FIRREA*).

will not be followed to hold directors “liable for gross negligence under Texas law as it exists now” in other businesses.³⁰⁶

Gross negligence in Texas is defined as “that entire want of care which would raise the belief that the act or omission complained of was the result of a conscious indifference to the right or welfare of the person or persons to be affected by it.”³⁰⁷ In *FDIC v. Harrington*, the Court concluded “that a director’s total abdication of duties falls within this definition of gross negligence.”³⁰⁸

The business judgment rule in Texas does not necessarily protect a director with respect to transactions in which he is “interested.” It simply means that the action will have to be challenged on duty of loyalty rather than duty of care grounds.³⁰⁹

(2) Reliance on Reports. Directors may in good faith and with ordinary care, rely on information, opinions, reports or statements, including financial statements and other financial data, prepared by officers or employees of the corporation, counsel, accountants, investment bankers or other persons as to matters the director reasonably believes are within the person’s professional or expert competence.³¹⁰

(3) Charter Limitations on Director Liability. The Tex. Corp. Stats. allow a Texas corporation to provide in its certificate of formation limitations on (or partial limitation of) director liability for monetary damages in relation to the duty of care.³¹¹ The liability of directors may not be so limited or eliminated, however, in connection with breaches of the duty

³⁰⁶ *Floyd v. Hefner*, C.A. No. H-03-5693, 2006 WL 2844245, at *28 (S.D. Tex. Sept. 29, 2006).

³⁰⁷ *Burk Royalty Co. v. Walls*, 616 S.W.2d 911, 920 (Tex. 1981) (citing *Missouri Pac. Ry. v. Shuford*, 10 S.W. 408, 411 (Tex. 1888)).

³⁰⁸ *Harrington*, 844 F. Supp. at 306 n.7.

³⁰⁹ *Gearhart*, 741 F.2d at 723 n.9.

³¹⁰ TBOC § 3.102 provides:

Sec. 3.102. RIGHTS OF GOVERNING PERSONS IN CERTAIN CASES. (a) In discharging a duty or exercising a power, a governing person, including a governing person who is a member of a committee, may, in good faith and with ordinary care, rely on information, opinions, reports, or statements, including financial statements and other financial data, concerning a domestic entity or another person and prepared or presented by:

- (1) an officer or employee of the entity;
 - (2) legal counsel;
 - (3) a certified public accountant;
 - (4) an investment banker;
 - (5) a person who the governing person reasonably believes possesses professional expertise in the matter; or
 - (6) a committee of the governing authority of which the governing person is not a member.
- (b) A governing person may not in good faith rely on the information described by Subsection (a) if the governing person has knowledge of a matter that makes the reliance unwarranted.

³¹¹ TMCLA art. 1302-7.06; TBOC § 7.001; *see supra* notes 297-309 and related text.

of loyalty, acts not in good faith, intentional misconduct or knowing violations of law, obtaining improper benefits or acts for which liability is expressly provided by statute.³¹²

(c) Other.

(1) Obedience. The duty of obedience in Texas requires a director to avoid committing *ultra vires* acts, i.e., acts beyond the scope of the powers of the corporation as defined by its articles of incorporation and Texas law.³¹³ An *ultra vires* act may be voidable under Texas law, but the director will not be held personally liable for such act unless the act is in violation of a specific statute or against public policy.

The RTC's complaint in *RTC v. Norris*³¹⁴ asserted that the directors of a failed financial institution breached their fiduciary duty of obedience by failing to cause the institution to adequately respond to regulatory warnings: "The defendants committed *ultra vires* acts by ignoring warnings from [regulators], by failing to put into place proper review and lending procedures, and by ratifying loans that did not comply with state and federal regulations and Commonwealth's Bylaws."³¹⁵ In rejecting this RTC argument, the Court wrote:

The RTC does not cite, and the court has not found, any case in which a disinterested director has been found liable under Texas law for alleged *ultra vires* acts of employees, absent pleadings and proof that the director knew of or took part in the act, even where the act is illegal.

....

Under the business judgment rule, Texas courts have refused to impose personal liability on corporate directors for illegal or *ultra vires* acts of corporate agents unless the directors either participated in the act or had actual knowledge of the act³¹⁶

2.6.4. Fiduciary Duties in Delaware Cases.

(a) Loyalty.

(1) Conflicts of Interest. In Delaware, the duty of loyalty mandates "that there shall be no conflict between duty and self-interest."³¹⁷ It demands that the best interests of the corporation and its stockholders take precedence over any personal interest or bias of a director that is not shared by stockholders generally.³¹⁸ The Delaware Court of Chancery has summarized the duty of loyalty as follows:

³¹² TMCLA art. 1302-7.06; TBOC § 7.001.

³¹³ *Gearhart*, 741 F.2d at 719.

³¹⁴ *RTC v. Norris*, 830 F. Supp. 351, 355 (S.D. Tex. 1993).

³¹⁵ *Id.*

³¹⁶ *Id.*

³¹⁷ *Guth v. Loft*, 5 A.2d 503, 510 (Del. 1939).

³¹⁸ *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993) ("*Technicolor I*").

Without intending to necessarily cover every case, it is possible to say broadly that the duty of loyalty is transgressed when a corporate fiduciary, whether director, officer or controlling shareholder, uses his or her corporate office or, in the case of a controlling shareholder, control over corporate machinery, to promote, advance or effectuate a transaction between the corporation and such person (or an entity in which the fiduciary has a substantial economic interest, directly or indirectly) and that transaction is not substantively fair to the corporation. That is, breach of loyalty cases inevitably involve conflicting economic or other interests, even if only in the somewhat diluted form present in every “entrenchment” case.³¹⁹

Importantly, conflicts of interest do not per se result in a breach of the duty of loyalty. Rather, it is the manner in which an interested director handles a conflict and the processes invoked to ensure fairness to the corporation and its stockholders that will determine the propriety of the director’s conduct and the validity of the particular transaction. Moreover, the Delaware courts have emphasized that only material personal interests or influences will imbue a transaction with duty of loyalty implications.

The duty of loyalty may be implicated in connection with numerous types of corporate transactions, including, for example, the following: contracts between the corporation and directors or entities in which directors have a material interest; management buyouts; dealings by a parent corporation with a subsidiary; corporate acquisitions and reorganizations in which the interests of a controlling stockholder and the minority stockholders might diverge;³²⁰ usurpations of corporate opportunities; competition by directors or officers with the corporation; use of corporate office, property or information for purposes unrelated to the best interest of the

³¹⁹ *Solash v. Telex Corp.*, No. 9518, 9528, 9525, 1988 WL 3587, at *7 (Del. Ch. 1988). Some of the procedural safeguards typically invoked to assure fairness in transactions involving Board conflicts of interest are discussed in more detail *infra*, in connection with the entire fairness standard of review.

³²⁰ *See New Jersey Carpenters Pension Fund v. infoGROUP, Inc.*, C.A. No. 5334-VCN, 2011 Del. Ch. LEXIS 147, at *27-28 (Del. Ch. Sept. 30, 2011, revised Oct. 6, 2011), in which the Court of Chancery refused to dismiss a breach of fiduciary duty claim where the plaintiff had adequately pled that the founder and largest stockholder of defendant *infoGROUP, Inc.* dominated his fellow directors and forced them to approve a sale of the company at an unfair price in order to provide himself with some much-needed liquidity; *but see In re Synthes, Inc. S’holder Litig.*, 50 A.3d 1022, 1024 (Del. Ch. 2012), in which plaintiff stockholders argued that a controlling stockholder refused to consider an acquisition offer that would have cashed out all the minority stockholders of the defendant *Synthes, Inc.*, but required the controlling stockholder to remain as an investor in *Synthes*; instead, the controlling stockholder worked with the other directors of *Synthes* and, after affording a consortium of private equity buyers a chance to make an all-cash, all-shares offer, ultimately accepted a bid made by Johnson & Johnson for 65% stock and 35% cash, and consummated a merger in which the controlling stockholder received the same treatment as the other stockholders. In *Synthes*, Chancellor Strine commented that although the controller was allowed by Delaware law to seek a premium for his own controlling position, he did not and instead allowed the minority to share ratably in the control premium paid by J&J, and in granting defendants’ motion to dismiss the Chancellor wrote:

I see no basis to conclude that the controlling stockholder had any conflict with the minority that justifies the imposition of the entire fairness standard. The controlling stockholder had more incentive than anyone to maximize the sale price of the company, and Delaware does not require a controlling stockholder to penalize itself and accept less than the minority, in order to afford the minority better terms. Rather, pro rata treatment remains a form of safe harbor under our law.”

corporation;³²¹ insider trading; and actions that have the purpose or practical effect of perpetuating directors in office. In Delaware, a director can be found guilty of a breach of duty of loyalty by approving a transaction in which the director did not personally profit, but did approve a transaction that benefited the majority stockholder to the detriment of the minority stockholders.³²²

Federal laws can subject corporate directors and officers to additional exposure in conflict of interest situations.³²³ Directors and officers have been convicted for “honest services fraud” under 18 U.S.C. § 1346 for entering into contracts on behalf of their employer with entities in which they held an interest without advising their employer of the interest.³²⁴

(2) **Good Faith.** Good faith is far from a new concept in Delaware fiduciary duty law.³²⁵ Good faith long was viewed by the Delaware courts as an integral component of the duty of loyalty. Then in 1993 *Cede & Co. v. Technicolor, Inc.*³²⁶ recognized the duty of good faith as a distinct directorial duty.³²⁷ The doctrinal concept that good faith is a separate leg in a triad of fiduciary duties died with the Delaware Supreme Court’s 2006 holding in *Stone v. Ritter* that good faith is not a separate fiduciary duty and is embedded in the duty of loyalty.³²⁸ In *Stone v. Ritter*,³²⁹ the Delaware Supreme Court explained that “good faith” is not a separate fiduciary duty like the duties of care and loyalty, but rather is embedded in the duty of loyalty:

[F]ailure to act in good faith results in two additional doctrinal consequences. First, although good faith may be described colloquially as part of a “triad” of fiduciary duties that includes the duties of care and loyalty, the

³²¹ *Kahn v. Kolberg Kravis Roberts & Co., L.P.*, 23 A.3d 831, 837 (Del. 2011) (“[A] fiduciary cannot use confidential corporate information for his own benefit. As the court recognized in *Brophy*, it is inequitable to permit the fiduciary to profit from using confidential corporate information. Even if the corporation did not suffer actual harm, equity requires disgorgement of that profit.”); *Brophy v. Cities Service Co.*, 70 A.2d 5, 7-8 (Del. Ch. 1949). To plead a claim under *Brophy v. Cities Service Co.* (a “*Brophy claim*”), a plaintiff must be able to allege that “1) the corporate fiduciary possessed material, nonpublic company information; and 2) the corporate fiduciary used that information improperly by making trades because she was motivated, in whole or in part, by the substance of that information.” *In re Oracle Corp. Derivative Litig.*, 867 A.2d 904, 934 (Del. Ch. 2004), *aff’d*, 872 A.2d 960 (Del. 2005); *see also In re Primedia, Inc. S’holders Litig. (Primedia III)*, Consolidated C.A. No. 6511-VCL, 2013 Del. Ch. LEXIS 306, at *3 (Del. Ch. Dec. 20, 2013); *In re Primedia, Inc. S’holders Litig. (Primedia II)*, 67 A.3d 455, 459 (Del. Ch. 2013).

³²² *Crescent/Mach I Partners, L.P. v. Turner*, 846 A.2d 963, n.50 (Del. Ch. 2000); *Strassburger v. Earley*, 752 A.2d 557, 581 (Del. Ch. 2000).

³²³ *See Appendix D – Effect of Sarbanes-Oxley Act of 2002 on Common Law Fiduciary Duties.*

³²⁴ 18 U.S.C. § 1346 defines “scheme or artifice to defraud” under the U.S. mail and wire fraud statutes to include “a scheme or artifice to deprive another of the intangible right to receive honest services.” 18 U.S.C. § 1346 (2012). *See* Frank C. Razzano and Kristin H. Jones, *Prosecution of Private Corporate Conduct – The Uncertainty Surrounding Honest Services Fraud*, 18 BUS. L. TODAY 37 (Jan.–Feb. 2009).

³²⁵ *See* Leo E. Strine Jr., Lawrence A. Hamermesh, R. Franklin Balotti and Jeffrey M. Gorris, *Loyalty’s Core Demand: The Defining Role of Good Faith in Corporation Law*, 93 GEO. L. J. 629 (2010), available at <http://ssrn.com/abstract=1349971>.

³²⁶ 634 A.2d 345, 361 (Del. 1993) (*Technicolor I*).

³²⁷ *See* Strine et al, *supra* note 325.

³²⁸ 911 A.2d 362, 369 (Del. 2006). *See infra* notes 352-362 and related text.

³²⁹ 911 A.2d 362 at 369.

obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty. Only the latter two duties, where violated, may directly result in liability, whereas a failure to act in good faith may do so, but indirectly. The second doctrinal consequence is that the fiduciary duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest.

The concept of good faith is also a limitation on the ability of entities to rely on Delaware statutes.³³⁰ In one of the early, landmark decisions analyzing the contours of the duty of loyalty, the Delaware Supreme Court observed that “no hard and fast rule can be formatted” for determining whether a director has acted in “good faith.”³³¹ While that observation remains true today, the case law and applicable commentary provide useful guidance regarding some of the touchstone principles underlying the duty of good faith.³³²

Good faith requires directors to act honestly, in the best interest of the corporation, and in a manner that is not knowingly unlawful or contrary to public policy. While the Court’s review requires it to examine the Board’s subjective motivation, the Court will utilize objective facts to infer such motivation. Like a duty of care analysis, such review likely will focus on the process by which the Board reached the decision under review. Consistent with earlier articulations of the level of conduct necessary to infer bad faith (or irrationality), more recent case law suggests that only fairly egregious conduct (such as a knowing and deliberate indifference to a potential risk of harm to the corporation) will rise to the level of “bad faith.”³³³

The impetus for an increased focus on the duty of good faith is the availability of damages as a remedy against directors who are found to have acted in bad faith. DGCL § 102(b)(7) authorizes corporations to include in their certificates of incorporation a provision eliminating or limiting directors’ liability for breaches of the fiduciary duty of care.³³⁴ However, DGCL § 102(b)(7) also expressly provides that directors cannot be protected from liability for either actions not taken in good faith³³⁵ or breaches of the duty of loyalty.³³⁶ A finding of a lack

³³⁰ In summarizing the Delaware doctrine of “independent legal significance” and that it is subject to the requirement of good faith, Leo E. Strine, Jr. wrote in *The Role of Delaware in the American Corporate Governance System, and Some Preliminary Musings on the Meltdown’s Implications for Corporate Law, Governance of the Modern Firm 2008*, Molengraaff Institute for Private Law, Utrecht University, Utrecht, The Netherlands (December 13, 2008):

The [DGCL] provides transactional planners with multiple routes to accomplish identical ends. Under the doctrine of independent legal significance, a board of directors is permitted to effect a transaction through whatever means it chooses in *good faith*. Thus, if one method would require a stockholder vote, and another would not, the board may choose the less complicated and more certain transactional method. (Emphasis added).

³³¹ See *Guth*, 5 A.2d at 510.

³³² See generally *Stone v. Ritter*, 911 A.2d 362, 364 (Del. 2006); *In re The Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 62 (Del. 2006); John F. Grossbauer and Nancy N. Waterman, *The (No Longer) Overlooked Duty of Good Faith Under Delaware Law*, VIII Deal Points No. 2 of 6 (The Newsletter of the ABA Business Law Section Committee on Negotiated Acquisitions, No. 2, Summer 2003).

³³³ *In re Disney*, 906 A.2d at 63.

³³⁴ See *infra* notes 555-559 and related text.

³³⁵ See Leo E. Strine Jr., Lawrence A. Hamermesh, R. Franklin Balotti and Jeffrey M. Gorris, *Loyalty’s Core Demand: The Defining Role of Good Faith in Corporation Law* (February 26, 2009), Georgetown Law

of good faith has profound significance for directors not only because they may not be exculpated from liability for such conduct, but also because a prerequisite to eligibility for indemnification under DGCL § 145 of the DGCL is that the directors who were unsuccessful in their litigation nevertheless must demonstrate that they have acted “in good faith and in a manner the person reasonably believed was in or not opposed to the best interests of the corporation.”³³⁷ Accordingly, a director who has breached the duty of good faith not only is exposed to personal liability, but also may not be able to seek indemnification from the corporation for any judgment obtained against her or for expenses incurred (unsuccessfully) litigating the issue of liability.³³⁸ Thus, in cases involving decisions made by directors who are disinterested and independent with respect to a transaction (and where, therefore, the duty of loyalty is not implicated), the duty of good faith still provides an avenue for asserting personal liability claims against the directors. Moreover, these claims, if successful, create barriers to indemnification of amounts paid by directors in judgment or settlement.³³⁹

(3) Waste. “Waste” constitutes “bad faith.” Director liability for waste requires proof that the directors approved an “exchange that is so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration.”³⁴⁰ Waste is a derivative claim.³⁴¹

Journal, Forthcoming; Widener Law School Legal Studies Research Paper No. 09-13; Harvard Law & Economics Discussion Paper No. 630, available at <http://ssrn.com/abstract=1349971>, 39-45 regarding the meaning of good faith in the context of DGCL § 102(b)(7) and the circumstances surrounding the addition of the good faith exclusion in DGCL § 102(b)(7).

³³⁶ Specifically, DGCL § 102(b)(7) authorizes the inclusion in a certificate of incorporation of:

A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) for any breach of the director’s duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under §174 of this title [dealing with the unlawful payment of dividends or unlawful stock purchase or redemption]; or (iv) for any transaction from which the director derived an improper personal benefit.

³³⁷ DGCL §§ 145(a)-(b).

³³⁸ In contrast, it is at least theoretically possible that a director who has been found to have breached his or her duty of loyalty could be found to have acted in good faith and, therefore, be eligible for indemnification of expenses (and, in non-derivative cases, amounts paid in judgment or settlement) by the corporation. See *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 663 (Del. Ch. 1988) (finding directors to have acted in good faith but nevertheless breached their duty of loyalty).

³³⁹ The availability of directors and officers liability insurance also may be brought into question by a finding of bad faith. Policies often contain exclusions that could be cited by carriers as a basis for denying coverage.

³⁴⁰ *In re Citigroup Inc. S’holder Derivative Litig.*, 964 A.2d 106, 137 (Del. Ch. 2009) (see *infra* note 665 and related text). See also *Sample v. Morgan*, 914 A.2d 647, 660 (Del. Ch. 2007) (see *infra* notes 645-647 and related text).

³⁴¹ *Thornton v. Bernard Tech., Inc.*, C.A. No. 962-VCN, 2009 WL 426179, at *3 (Del. Ch. Feb. 20, 2009) (“When a director engages in self-dealing or commits waste, he takes from the corporate treasury and any recovery would flow directly back into the corporate treasury.”).

(4) Oversight/Caremark. Directors also may be found to have violated the duty of loyalty when they fail to act in the face of a known duty to act³⁴² – i.e., they act in bad faith.³⁴³ In an important Delaware Chancery Court decision on this issue, *In re Caremark International, Inc. Derivative Litigation*,³⁴⁴ the settlement of a derivative action that involved claims that Caremark’s Board breached its fiduciary duty to the company in connection with alleged violations by the company of anti-referral provisions of Federal Medicare and Medicaid statutes was approved. In so doing, the Court discussed the scope of a Board’s duty to supervise or monitor corporate performance and stay informed about the business of the corporation as follows:

[I]t would . . . be a mistake to conclude . . . that corporate boards may satisfy their obligations to be reasonably informed concerning the corporation, without assuring themselves that information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation’s compliance with law and its business performance.³⁴⁵

Stated affirmatively, “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 . . . render a director liable.”³⁴⁶ While *Caremark* recognizes a cause of action for uninformed inaction, the holding is subject to the following:

First, the Court held that “only a sustained or systematic failure of the board to exercise oversight — such as an utter failure to attempt to assure a reasonable information and reporting system exists — will establish the lack of good faith that is a necessary condition to liability.”³⁴⁷ It is thus not at all clear that a plaintiff could recover based on a single example of director inaction, or even a series of examples relating to a single subject.

³⁴² See Business Leaders Must Address Cybersecurity Risk attached as Appendix D to Byron F. Egan, *How Recent Fiduciary Duty Cases Affect Advice to Directors and Officers of Delaware and Texas Corporations*, UTCLE 37th Annual Conference on Securities Regulation and Business Law, Feb. 13, 2015, available at <http://www.jw.com/publications/article/2033>; see also John F. Olson, Jonathan C. Dickey, Amy L. Goodman and Gilliam McPhee, *Current Issues in Director and Officer Indemnification and Insurance*, INSIGHTS: THE CORPORATE & SECURITIES LAW ADVISOR, Jul. 31, 2013, at 8 (“As part of the board’s risk oversight function, the board should have an understanding of the cyber risks the company faces in operating its business and should be comfortable that the company has systems in place to identify and manage cyber risks, prevent cyber breaches and respond to cyber incidents when they occur. This should include an understanding of the extent to which a company’s insurance may provide protection in the event of a major cyber incident.”).

³⁴³ In *Stone v. Ritter*, the Delaware Supreme Court held that “the requirement to act in good faith is a subsidiary element, i.e., a condition, of the fundamental duty of loyalty.” 911 A.2d at 370 (internal quotations omitted).

³⁴⁴ 698 A.2d 959, 970 (Del. Ch. 1996); see Regina F. Burch, *Director Oversight and Monitoring: The Standard of Care and The Standard of Liability Post-Enron*, 6 WYO. L. REV. 482, 485 (2006).

³⁴⁵ *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d at 970.

³⁴⁶ *Id.*

³⁴⁷ *Id.* at 971.

Second, *Caremark* noted that “the level of detail that is appropriate for such an information system is a question of business judgment,”³⁴⁸ which indicates that the presence of an existing information and reporting system will do much to cut off any derivative claim, because the adequacy of the system itself will be protected.

Third, *Caremark* considered it obvious that “no rationally designed information system . . . will remove the possibility” that losses could occur.³⁴⁹ As a result, “[a]ny action seeking recovery for losses would logically entail a judicial determination of proximate cause.”³⁵⁰ This holding indicates that a loss to the corporation is not itself evidence of an inadequate information and reporting system. Instead, the Court will focus on the adequacy of the system overall and whether a causal link exists.³⁵¹

In *Stone v. Ritter*³⁵² the Delaware Supreme Court affirmed *Caremark* as the standard for assessing director oversight responsibility. *Stone v. Ritter* was a “classic *Caremark* claim” arising out of a bank paying \$50 million in fines and penalties to resolve government and regulatory investigations pertaining principally to the failure of bank employees to file Suspicious Activity Reports (“*SARs*”) as required by the Bank Secrecy Act (“*BSA*”) and various anti money laundering regulations. The Chancery Court dismissed the plaintiffs’ derivative complaint which alleged that “the defendants had utterly failed to implement any sort of statutorily required monitoring, reporting or information controls that would have enabled them to learn of problems requiring their attention.” In affirming the Chancery Court, the Delaware Supreme Court commented, “[i]n this appeal, the plaintiffs acknowledge that the directors neither ‘knew [n]or should have known that violations of law were occurring,’ i.e., that there were no ‘red flags’ before the directors” and held “[c]onsistent with our opinion in *In re Walt Disney Co. Derivative Litigation*,³⁵³ . . . that *Caremark* articulates the necessary conditions for assessing director oversight liability and . . . that the *Caremark* standard was properly applied to evaluate the derivative complaint in this case.”

³⁴⁸ *Id.* at 970.

³⁴⁹ *Id.*

³⁵⁰ *Id.* at 970 n.27.

³⁵¹ See generally Eisenberg, *Corporate Governance The Board of Directors and Internal Control*, 19 CARDOZO L. REV. 237 (1997); Pitt, et al., *Talking the Talk and Walking the Walk: Director Duties to Uncover and Respond to Management Misconduct*, 1005 PLI/CORP. 301, 304 (1997); Gruner, *Director and Officer Liability for Defective Compliance Systems: Caremark and Beyond*, 995 PLI/CORP. 57, 64-70 (1997); Funk, *Recent Developments in Delaware Corporate Law: In re Caremark International Inc. Derivative Litigation: Director Behavior, Shareholder Protection, and Corporate Legal Compliance*, 22 DEL. J. CORP. L. 311 (1997). Cf. *In re Abbott Laboratories Derivative Shareholders Litigation*, 325 F.3d 795, 804 (7th Cir. 2003) (the Seventh Circuit applying Illinois law in a shareholders derivative suit denied motion to dismiss and distinguished *Caremark* on the grounds that in the latter, there was no evidence indicating that the directors “conscientiously permitted a known violation of law by the corporation to occur,” unlike evidence to the contrary in *Abbott*, but nonetheless relied on *Caremark* language regarding the connection between a board’s systemic failure of oversight and a lack of good faith); *Connolly v. Gasmire*, 257 S.W.3d 831, 851 (Tex. App.—Dallas 2008, no pet.) (a Texas court in a derivative action involving a Delaware corporation declined to follow *Abbott* as the Court found no Delaware case in which *Abbott* had been followed).

³⁵² 911 A.2d 362, 365 (Del. 2006).

³⁵³ See *In re The Walt Disney Co. Derivative Litigation*, 906 A.2d 27, 63 (Del. 2006).

The Supreme Court of Delaware explained the doctrinal basis for its holding as follows and, in so doing, held that “good faith” is not a separate fiduciary duty and is embedded in the duty of loyalty:

As evidenced by the language quoted above, the *Caremark* standard for so-called “oversight” liability draws heavily upon the concept of director failure to act in good faith. That is consistent with the definition(s) of bad faith recently approved by this Court in its recent *Disney* decision, where we held that a failure to act in good faith requires conduct that is qualitatively different from, and more culpable than, the conduct giving rise to a violation of the fiduciary duty of care (i.e., gross negligence). In *Disney*, we identified the following examples of conduct that would establish a failure to act in good faith:

A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties. There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient.

The third of these examples describes, and is fully consistent with, the lack of good faith conduct that the *Caremark* Court held was a “necessary condition” for director oversight liability, i.e., “a sustained or systematic failure of the board to exercise oversight – such as an utter failure to attempt to assure a reasonable information and reporting system exists” Indeed, our opinion in *Disney* cited *Caremark* with approval for that proposition. Accordingly, the Court of Chancery applied the correct standard in assessing whether demand was excused in this case where failure to exercise oversight was the basis or theory of the plaintiffs’ claim for relief.

It is important, in this context, to clarify a doctrinal issue that is critical to understanding fiduciary liability under *Caremark* as we construe that case. The phraseology used in *Caremark* and that we employ here – describing the lack of good faith as a “necessary condition to liability” – is deliberate. The purpose of that formulation is to communicate that a failure to act in good faith is not conduct that results, *ipso facto*, in the direct imposition of fiduciary liability. The failure to act in good faith may result in liability because the requirement to act in good faith “is a subsidiary element[,]” i.e., a condition, “of the fundamental duty of loyalty.” It follows that because a showing of bad faith conduct, in the sense described in *Disney* and *Caremark*, is essential to establish director oversight liability, the fiduciary duty violated by that conduct is the duty of loyalty.

This view of a failure to act in good faith results in two additional doctrinal consequences. First, although good faith may be described colloquially as part of a “triad” of fiduciary duties that includes the duties of care and loyalty,

the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty. Only the latter two duties, where violated, may directly result in liability, whereas a failure to act in good faith may do so, but indirectly. The second doctrinal consequence is that the fiduciary duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest. It also encompasses cases where the fiduciary fails to act in good faith. As the Court of Chancery aptly put it in *Guttman*, “[a] director cannot act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation’s best interest.”

We hold that *Caremark* articulates the necessary conditions predicate for director oversight liability: (a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention. In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations. Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith.³⁵⁴

Stone v. Ritter was a “demand-excused” case in which the plaintiffs did not demand that the directors commence the derivative action because allegedly the directors breached their oversight duty and, as a result, faced a “substantial likelihood of liability” as a result of their “utter failure” to act in good faith to put into place policies and procedures to ensure compliance with regulatory obligations. The Court of Chancery found that the plaintiffs did not plead the existence of “red flags” – “facts showing that the board ever was aware that company’s internal controls were inadequate, that these inadequacies would result in illegal activity, and that the board chose to do nothing about problems it allegedly knew existed.”³⁵⁵ In dismissing the derivative complaint, the Court of Chancery concluded:

This case is not about a board’s failure to carefully consider a material corporate decision that was presented to the board. This is a case where information was not reaching the board because of ineffective internal controls.... With the benefit of hindsight, it is beyond question that AmSouth’s internal controls with respect to the Bank Secrecy Act and anti-money laundering regulations compliance were inadequate. Neither party disputes that the lack of internal controls resulted in a huge fine--\$50 million, alleged to be the largest ever of its kind. The fact of those losses, however, is not alone enough for a court to conclude that a majority of the corporation’s board of directors is disqualified from considering demand that AmSouth bring suit against those responsible.³⁵⁶

³⁵⁴ 911 A.2d at 369-70.

³⁵⁵ *Id.* at 370.

³⁵⁶ *Id.* at 370-71.

The adequacy of the plaintiffs’ assertion that demand was excused turned on whether the complaint alleged facts sufficient to show that the defendant directors were potentially personally liable for the failure of non-director bank employees to file the required Suspicious Activity Reports. In affirming the Chancery Court, the Delaware Supreme Court wrote:

For the plaintiffs’ derivative complaint to withstand a motion to dismiss, “only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability.” As the *Caremark* decision noted:

Such a test of liability – lack of good faith as evidenced by sustained or systematic failure of a director to exercise reasonable oversight – is quite high. But, a demanding test of liability in the oversight context is probably beneficial to corporate shareholders as a class, as it is in the board decision context, since it makes board service by qualified persons more likely, while continuing to act as a stimulus to *good faith performance of duty* by such directors.

The KPMG Report – which the plaintiffs explicitly incorporated by reference into their derivative complaint – refutes the assertion that the directors “never took the necessary steps . . . to ensure that a reasonable BSA compliance and reporting system existed.” KPMG’s findings reflect that the Board received and approved relevant policies and procedures, delegated to certain employees and departments the responsibility for filing SARs and monitoring compliance, and exercised oversight by relying on periodic reports from them. Although there ultimately may have been failures by employees to report deficiencies to the Board, there is no basis for an oversight claim seeking to hold the directors personally liable for such failures by the employees.

With the benefit of hindsight, the plaintiffs’ complaint seeks to equate a bad outcome with bad faith. The lacuna in the plaintiffs’ argument is a failure to recognize that the directors’ good faith exercise of oversight responsibility may not invariably prevent employees from violating criminal laws, or from causing the corporation to incur significant financial liability, or both, as occurred in *Graham*, *Caremark* and this very case. In the absence of red flags, good faith in the context of oversight must be measured by the directors’ actions “to assure a reasonable information and reporting system exists” and not by second-guessing after the occurrence of employee conduct that results in an unintended adverse outcome. Accordingly, we hold that the Court of Chancery properly applied *Caremark* and dismissed the plaintiffs’ derivative complaint for failure to excuse demand by alleging particularized facts that created reason to doubt whether the directors had acted in good faith in exercising their oversight responsibilities.³⁵⁷

³⁵⁷ *Id.* at 372-73.

Good faith in Delaware nevertheless requires active, engaged directorship including having a basis for confidence that the corporation's system of controls is adequate for its business, even if that business is in China and travel and foreign language skills are required:

[I]f you're going to have a company domiciled for purposes of its relations with its investors in Delaware and the assets and operations of that company are situated in China ... in order for you to meet your obligation of good faith, you better have your physical body in China an awful lot. You better have in place a system of controls to make sure that you know that you actually own the assets. You better have the language skills to navigate the environment in which the company is operating. You better have retained accountants and lawyers who are fit to the task of maintaining a system of controls over a public company.... Independent directors who step into these situations involving essentially the fiduciary oversight of assets in other parts of the world have a duty not to be dummy directors.... [Y]ou're not going to be able to sit in your home in the U.S. and do a conference call four times a year and discharge your duty of loyalty. That won't cut it.... You have a duty to think.³⁵⁸

In *American International Group, Inc. Consolidated Derivative Litigation; AIG, Inc. v. Greenberg*, the Court denied a motion to dismiss *Caremark* claims against former Chairman of American International Group, Inc. ("*AIG*") Maurice "Hank" Greenberg, three other directors (who were also executive officers part of Greenberg's "*Inner Circle*") and other AIG directors for harm AIG suffered when it was revealed that AIG's financial statements overstated the value of AIG by billions of dollars and that AIG had engaged in schemes to evade taxes and rig insurance markets.³⁵⁹ The Court emphasized that the claims were not based on one instance of fraud, but rather a pervasive scheme of extraordinary illegal misconduct at the direction and under the control of defendant Greenberg and his Inner Circle, and wrote: "Our Supreme Court has recognized that directors can be liable where they 'consciously failed to monitor or oversee [the company's internal controls] thus disabling themselves from being informed of risks or problems requiring their attention.'"³⁶⁰ Recognizing that this standard requires scienter, the Court found pled facts that supported an inference that two of the defendant directors were conscious of the fact that they were not doing their jobs.³⁶¹

Shortly thereafter, in *In re Citigroup Inc. Shareholder Derivative Litigation*,³⁶² the Chancery Court distinguished *AIG* and dismissed *Caremark* claims³⁶³ brought against current

³⁵⁸ *In re Puda Coal Stockholders' Litigation*, C.A. No. 6476-CS at 17-18, 21-22, (Del. Ch. Feb. 6, 2013) (bench ruling) available at www.davispolk.com/files/uploads/Puda_Coal_Transcript_Ruling.pdf.

³⁵⁹ 965 A.2d 763, 774 (Del. Ch. 2009).

³⁶⁰ *Id.* at 799 (citation omitted).

³⁶¹ Breach of fiduciary duty claims were also not dismissed against AIG directors alleged to have used insider information to profit at the expense of innocent buyers of stock, with the Court writing: "Many of the worst acts of fiduciary misconduct have involved frauds that personally benefited insiders as an indirect effect of directly inflating the corporation's stock price by the artificial means of cooking the books."

³⁶² 964 A.2d 106, 111 (Del. Ch. 2009).

³⁶³ Plaintiffs had not made demand on the Board, alleging that it would have been futile since the directors were defendants in the action and faced substantial liability if the action succeeded. Chancellor Chandler disagreed that demand was excused. He started his analysis by referring to the test articulated by the

and former directors of Citigroup for failing to properly monitor and manage the risks that Citigroup faced concerning problems in the subprime lending market. Plaintiffs claimed that there were extensive “red flags” that should have put defendants on notice about problems “that were brewing in the real estate and credit markets,” and that defendants ignored the warnings and sacrificed the long term viability of Citigroup for short term profits.³⁶⁴ In analyzing the plaintiffs’ theory of director liability under the teachings of *Caremark*, the the Court found that the plaintiffs’ claims were in essence that the defendants failed to monitor the Company’s “business risk” with respect to Citigroup’s exposure to the subprime mortgage market.

Since Citigroup had a DGCL § 102(b)(7) provision in its certificate of incorporation³⁶⁵ and the plaintiffs had not alleged that the directors were interested in the transaction, the plaintiffs had to allege with particularity that the directors acted in bad faith. The Court said that a plaintiff can “plead bad faith by alleging with particularity that a director *knowingly* violated a fiduciary duty or failed to act in violation of a *known* duty to act, demonstrating a *conscious* disregard for her duties.”³⁶⁶ In addressing whether the director consciously disregarded an obligation to be reasonably informed about the business and the risks or consciously disregard the duty to monitor and oversee the business, the Court wrote:

The presumption of the business judgment rule, the protection of an exculpatory § 102(b)(7) provision, and the difficulty of proving a *Caremark* claim together function to place an extremely high burden on a plaintiff to state a claim for personal director liability for failure to see the extent of a company’s business risk.

To the extent the Court allows shareholder plaintiffs to succeed on a theory that a director is liable for a failure to monitor business risk, the Court risks undermining the well settled policy of Delaware law by inviting Courts to perform a hindsight evaluation of the reasonableness or prudence of directors’ business decisions. Risk has been defined as the chance that a return on an investment will be different that [sic] expected. The essence of the business judgment of managers and directors is deciding how the company will evaluate the trade-off between risk and return. Businesses—and particularly financial institutions—make returns by taking on risk; a company or investor that is willing to take on more risk can earn a higher return. Thus, in almost any business

Delaware Supreme Court in *Aronson v. Lewis*, 473 A.2d 805, 809 (Del. 1984), for demand futility where plaintiffs must provide particularized factual allegations that raise a reasonable doubt that the directors are disinterested and that the challenged transaction was otherwise the product of a valid exercise of business judgment, but found that the plaintiffs were complaining about board “inaction” and as a result, the *Aronson* test did not apply. Instead, in order to show demand futility in this situation, the applicable standard is from *Rales v. Blasband*, 634 A.2d 927, 933 (Del. 1993), which requires that a plaintiff must allege particularized facts that “create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to the demand.”

³⁶⁴ *Id.* at 111.

³⁶⁵ *See supra* notes 336-337 and related text.

³⁶⁶ *Citigroup*, 964 A.2d at 125.

transaction, the parties go into the deal with the knowledge that, even if they have evaluated the situation correctly, the return could be different than they expected.

It is almost impossible for a court, in hindsight, to determine whether the directors of a company properly evaluated risk and thus made the “right” business decision. In any investment there is a chance that returns will turn out lower than expected, and generally a smaller chance that they will be far lower than expected. When investments turn out poorly, it is possible that the decision-maker evaluated the deal correctly but got “unlucky” in that a huge loss—the probability of which was very small—actually happened. It is also possible that the decision-maker improperly evaluated the risk posed by an investment and that the company suffered large losses as a result.

Business decision-makers must operate in the real world, with imperfect information, limited resources, and an uncertain future. To impose liability on directors for making a “wrong” business decision would cripple their ability to earn returns for investors by taking business risks. Indeed, this kind of judicial second guessing is what the business judgment rule was designed to prevent, and even if a complaint is framed under a *Caremark* theory, this Court will not abandon such bedrock principles of Delaware fiduciary duty law. With these considerations and the difficult standard required to show director oversight liability in mind, I turn to an evaluation of the allegations in the Complaint.³⁶⁷

In light of the “extremely high burden” placed on plaintiffs, the Court concluded that plaintiffs’ conclusory allegations (and thus their failure to plead particularized facts) were insufficient to state a *Caremark* claim thereby excusing demand. The Court compared *Citigroup* with the *American International Group, Inc. Consolidated Derivative Litigation*³⁶⁸ where, unlike the allegations against the Citigroup directors, the defendant directors in the *AIG* case were charged with failure to exercise reasonable oversight over pervasive *fraudulent* and *criminal* conduct:

This Court’s recent decision in *American International Group, Inc. Consolidated Derivative Litigation* demonstrates the stark contrast between the allegations here and allegations that are sufficient to survive a motion to dismiss. In *AIG*, the Court faced a motion to dismiss a complaint that included “well-pled allegations of pervasive, diverse, and substantial financial fraud involving managers at the highest levels of AIG.” In concluding that the complaint stated a claim for relief under Rule 12(b)(6), the Court held that the factual allegations in the complaint were sufficient to support an inference that AIG executives running those divisions knew of and approved much of the wrongdoing. The Court reasoned that huge fraudulent schemes were unlikely to be perpetrated without the knowledge of the executive in charge of that division of the company. Unlike the

³⁶⁷ *Id.* at 125-26; *cf In re The Goldman Sachs Group, Inc. Shareholder Litigation*, C.A. No. 5215-VCG, 2011 Del. Ch. LEXIS 151, at *72 (Del Ch. Oct. 12, 2011) (court refrained from reading into *Caremark* a further duty to “monitor business risk”).

³⁶⁸ *See supra* note 359 and related text.

allegations in this case, the defendants in *AIG* allegedly failed to exercise reasonable oversight over pervasive *fraudulent* and *criminal* conduct. Indeed, the Court in *AIG* even stated that the complaint there supported the assertion that top AIG officials were leading a “criminal organization” and that “[t]he diversity, pervasiveness, and materiality of the alleged financial wrongdoing at AIG is extraordinary.”

Contrast the *AIG* claims with the claims in this case. Here, plaintiffs argue that the Complaint supports the reasonable conclusion that the director defendants acted in bad faith by failing to see the warning signs of a deterioration in the subprime mortgage market and failing to cause Citigroup to change its investment policy to limit its exposure to the subprime market. Director oversight duties are designed to ensure reasonable reporting and information systems exist that would allow directors to know about and prevent wrongdoing that could cause losses for the Company. There are significant differences between failing to oversee employee fraudulent or criminal conduct and failing to recognize the extent of a Company’s business risk. Directors should, indeed must under Delaware law, ensure that reasonable information and reporting systems exist that would put them on notice of fraudulent or criminal conduct within the company. Such oversight programs allow directors to intervene and prevent frauds or other wrongdoing that could expose the company to risk of loss as a result of such conduct. While it may be tempting to say that directors have the same duties to monitor and oversee business risk, imposing *Caremark*-type duties on directors to monitor business risk is fundamentally different. Citigroup was in the business of taking on and managing investment and other business risks. To impose oversight liability on directors for failure to monitor “excessive” risk would involve courts in conducting hindsight evaluations of decisions at the heart of the business judgment of directors. Oversight duties under Delaware law are not designed to subject directors, even expert directors, to *personal liability* for failure to predict the future and to properly evaluate business risk.³⁶⁹

The reasoning for the foregoing statement of Delaware law was explained by means of the following query by the Court in footnote 78:

Query: if the Court were to adopt plaintiffs’ theory of the case—that the defendants are personally liable for their failure to see the problems in the subprime mortgage market and Citigroup’s exposure to them—then could not a plaintiff succeed on a theory that a director was personally liable for failure to predict the extent of the subprime mortgage crisis and profit from it, even if the company was not exposed to losses from the subprime mortgage market? If directors are going to be held liable for losses for failing to accurately predict market events, then why not hold them liable for failing to profit by predicting market events that, in hindsight, the

³⁶⁹ *Citigroup*, 964 A.2d at 130-31.

director should have seen because of certain red (or green?) flags? If one expects director prescience in one direction, why not the other?³⁷⁰

The Court observed that the plaintiffs were asking it to engage in the exact kind of judicial second guessing that the business judgment rule proscribes. Especially in a case with staggering losses, it would be tempting to examine why the decision was wrong, but the presumption of the business judgment rule against an objective review of business decisions by judges is no less applicable when losses to the company are large.

(5) Business Opportunities. Like its Texas counterpart, the corporate opportunity doctrine in Delaware prohibits an officer or director of a corporation from diverting a business opportunity presented to, or otherwise rightfully belonging to, the corporation to himself or any of his affiliates. In Delaware, the corporate opportunity doctrine dictates 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 inimical to his duties to the corporation. *Guth v. Loft, Inc.*³⁷¹ sets forth a widely quoted test for determining whether a director or officer wrongfully has diverted a corporate opportunity:

if there is presented to a corporate officer or director a business opportunity which the corporation is financially able to undertake, is, from its nature, in the line of the corporation's business and is of practical advantage to it, is one in which the corporation has an interest or a reasonable expectancy, and, by embracing the opportunity, the self-interest of the officer or director will be brought into conflict with that of the corporation, the law will not permit him to seize the opportunity for himself.

Guth was explained and updated in 1996 by the Delaware Supreme Court in *Broz v. Cellular Info. Systems, Inc.*³⁷² as follows:

The corporate opportunity doctrine, as delineated by *Guth* and its progeny, 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. The Court in *Guth* also derived a corollary which states that a director or officer *may* take a corporate opportunity if: (1) the opportunity is presented to the director or officer in his individual and not his corporate capacity; (2) the opportunity is not essential to the corporation; (3) the corporation holds no interest or expectancy in the opportunity; and (4) the director or officer has not

³⁷⁰ *Id.* at 131 n.78.

³⁷¹ 5 A.2d 503, 510-11 (Del. 1939).

³⁷² 673 A.2d 148 (Del. 1996).

wrongfully employed the resources of the corporation in pursuing or exploiting the opportunity. *Guth*, 5 A.2d at 509.

Thus, the contours of this doctrine are well established. It is important to note, however, that the tests enunciated in *Guth* and subsequent cases provide guidelines to be considered by a reviewing court in balancing the equities of an individual case. No one factor is dispositive and all factors must be taken into account insofar as they are applicable. * * *

Under Delaware law, even if the corporation cannot establish its financial capability to have exploited the opportunity, the element will be met if the usurping party had a parallel contractual obligation to present corporate opportunities to the corporation. The question of whether a director has usurped a business opportunity requires a fact-intensive analysis. Further, the defendant has the burden of proof to show that he did not usurp an opportunity that belonged to the corporation.

Like Texas, Delaware law allows a corporation to renounce any interest in business opportunities presented to the corporation or one or more of its officers, directors or shareholders in its certificate of formation or by action of its Board.³⁷³ While this permits a corporation to specifically forgo individual corporate opportunities or classes of opportunities, the type of judicial scrutiny applied to the decision to make any such renunciation of corporate opportunities will generally be governed by a traditional common law fiduciary duty analysis.

(6) Confidentiality. A director may not use confidential company information, or disclose it to third parties, for personal gain without authorization from his fellow directors.³⁷⁴ This principle is often memorialized in corporate policies.³⁷⁵ In *Shocking Technologies, Inc. v. Michael*,³⁷⁶ a director (“*Michael*”) of a privately held Delaware corporation in dire financial straits who was on the Board as the representative of two series of preferred stock, was sued by the corporation for breaching his duty of loyalty by leaking negative confidential information about the company to another preferred shareholder considering an additional investment in the company. The Delaware Court of Chancery found that Michael disclosed the confidential information (i) to encourage the potential investor to withhold funds the corporation desperately needed, thereby making the company accommodating to the governance changes sought by Michael, or (ii) if the investor nevertheless decided to invest, to help the investor get a “better deal” which would include Board representation for such investor (thereby changing the balance

³⁷³ DGCL § 122(17).

³⁷⁴ *Hollinger Int’l Inc. v. Black*, 844 A.2d 1022, 1062 (Del Ch., 2004), *aff’d sub. nom.*, *Black v. Hollinger Int’l Inc.*, 872 A.2d 559 (Del. 2005); *Agranoff v. Miller*, C.A. No. 16795, 1999 WL 219650, at *19 (Del. Ch. Apr. 12, 1999), *aff’d as modified*, 737 A.2d 530 (Del. 1999).

³⁷⁵ *See Disney v. Walt Disney Co.*, C.A. No. 234-N (Remand Opinion June 20, 2005), discussing a written confidentiality policy of The Walt Disney Company that bars present and former directors from disclosing information entrusted to them by reason of their positions, including information about discussions and deliberations of the Board). *See* The Walt Disney Company Code of Business Conduct and Ethics for Directors available at <http://thewaltdisneycompany.com/content/code-business-conduct-and-ethics-directors>.

³⁷⁶ C.A. No. 7164-VCN, 2012 Del. Ch. LEXIS 224, at *3 (Del. Ch. Oct. 1, 2012).

of power on the Board in Michael’s favor). In holding that Michael had violated his duty of loyalty, the Chancery Court explained:

The fiduciary duty of loyalty imposes on a director “an affirmative obligation to protect and advance the interests of the corporation” and requires a director “absolutely [to] refrain from any conduct that would harm the corporation”. Encompassed within the duty of loyalty is a good faith aspect as well. “To act in good faith, a director must act at all times with an honesty of purpose and in the best interest and welfare of the corporation. **A director acting in subjective good faith may, nevertheless, breach his duty of loyalty. The “essence of the duty of loyalty” stands for the fundamental proposition that a director, even if he is a shareholder, may not engage in conduct that is “adverse to the interests of [his] corporation.”**” (Emphasis added)

The *Shocking Technologies* case involved a dissident director who was the sole Board representative of two series of preferred stock. Over time, significant disagreements between Michael and the other Board members arose over executive compensation and whether there should be increased Board representation for the preferred stock. Michael argued that the company’s governance problems would need to be resolved before it could attract additional equity funding. The other directors believed, however, that these disagreements were a pretext for Michael’s desire to increase his influence and control over the Board at a time when the company faced financial difficulties.

As the disagreements escalated, Michael contacted another holder of preferred stock who represented the company’s only remaining source of capital to discourage the holder from exercising its warrants to purchase additional shares of the company’s stock. Michael also told the potential investor that the company was in a dire financial situation, that the investor was the only present source of financing, and that the investor should use this leverage to negotiate for more favorable terms, such as a lower price or Board representation. The Court found that Michael shared this confidential information with the potential investor because Michael anticipated that he would be more likely to achieve his goals if the investor either (i) withheld any additional investment in the company, thereby leaving the company desperate for funding,³⁷⁷ or (ii) used the confidential information to get better deal terms, which Michael believed would undercut the authority of the balance of the Board.

In rejecting Michael’s argument that his efforts were intended to “better the corporate governance structure” of the company and “reduce [the CEO’s] domination” of the Board, the Court wrote:

Michael may, for some period of time, have been motivated by idealistic notions of corporate governance. It was no doubt convenient that his corporate governance objectives aligned nicely with his self-interest.³⁷⁸ When he and his

³⁷⁷ The company alleged that Michael was seeking to force the company into a new down round share issuance in which Michael could purchase shares on the cheap and dilute the other stockholders.

³⁷⁸ See *City Capital Assocs. Ltd. P’ship v. Interco. Inc.*, 551 A.2d 787, 796 (Del. Ch. 1988) (“human nature may incline *even one acting in subjective good faith* to rationalize as right that which is merely personally beneficial”).

fellow B/C [series of preferred stock] investors bought into Shocking, they did so knowing that they collectively only had one out of six board slots. Apparently, Michael came to regret that decision and worked to avoid the deal that he made. He contrasted the one out of six board seats designated by the B/C investors with B/C investors' substantial shares of all funds invested in Shocking.³⁷⁹ That disparity annoyed him, but it was the board representation which he negotiated. In the abstract, his argument that board representation should be more proportional to investment is plausible. To describe it as a matter of good corporate governance—something that he may have believed or rationalized in contravention of the investment commitments that he made—strikes an observer from a distance as somewhere between disingenuous and self-righteous self-interest.

* * *

Regardless of how one might prioritize Michael's corporate governance concepts, those objectives would not justify pushing the Company to the brink of—or beyond—a debilitating cash shortfall. It is not an act of loyalty for a director to seek to impose his subjective views of what might be better for the Company by exercising whatever power he may have to threaten the Company's survival. In short, even if Michael had reasonable goals, he chose improper means, including disclosure of confidential information, in an attempt to achieve them.

Michael's conduct had a foreseeable (and intended) consequence: depriving the Company of a cash infusion necessary for its short-term survival. It turns out that a predictable result of his actions did not occur. In these circumstances, a director may not put the existence of a corporation at risk in order to bolster his personal views of corporate governance. The lesson to be learned from these facts must be carefully confined, however. First, fair debate may be an important aspect of board performance. A board majority may not muzzle a minority board member simply because it does not like what she may be saying. Second, criticism of the conduct of a board majority does not necessarily equate with criticism of the corporation and its mission. The majority may be managing the business and affairs of the corporation, but a dissident board member has significant freedom to challenge the majority's decisions and to share her concerns with other shareholders. On the other hand, internal disagreement will not generally allow a dissident to release confidential corporate information. Fiduciary obligations are shaped by context. A balancing of the various conflicting factors will be necessary, and sometimes the judgments will be difficult. Here, the most logical objective of Michael's actions—strangling the Company with a potentially catastrophic cash shortfall—cannot be reconciled with his 'unremitting' duty of loyalty. Thus, Michael did breach his fiduciary duty of loyalty to Shocking.

³⁷⁹ Michael believed that the B/C series investors had contributed 70% of the capital paid in to the company.

The Court recognized that the crucible of director debate can be good for the corporation, albeit frustrating to the protagonists:

Shareholders and directors, sometimes to the chagrin of a majority of the board of directors, may seek to change corporate governance ambiance and board composition. That is not merely permitted conduct; such efforts may be entitled to affirmative protection as part of the shareholder franchise. Michael's objectives as to his corporate governance agenda were not proscribed. They may have been prudent, or they may have been irresponsible. Nonetheless, it was his right to make such policy choices.

The steps that a shareholder-director may take to achieve objectives are not without limits. A director may not harm the corporation by, for example, interfering with crucial financing efforts in an effort to further such objectives. Moreover, he may not use confidential information, especially information gleaned because of his board membership, to aid a third party which has a position necessarily adverse to that of the corporation.³⁸⁰

The Court in *Shocking Technologies*, however, found that the director went too far in pursuing his objective by his disclosure of confidential information to a third party dealing with the corporation:

Michael may have hoped that his disclosure of confidential information to Dickinson [the investor] would have ultimately resulted in better corporate governance practices for Shocking [the corporation]. That hope, however, cannot outweigh or somehow otherwise counterbalance the foreseeable harm that he would likely cause Shocking. Notwithstanding his good intentions, his taking steps that would foreseeably cause significant harm to Shocking amounts to nothing less than a breach of the fiduciary duty of loyalty.

The Court, however, did not award damages to the corporation as it did not find that there were any material damages suffered by the corporation and found that the director did not manifest the "subjective bad faith" required for an award of attorney's fees to the corporation. The Court appeared concerned that shifting fees may be too much of a penalty for a dissident director, and may make it too easy for the majority to use as a "hammer" to silence those members of the Board who dissent, explaining: "The line separating fair and aggressive debate from disloyal conduct may be less than precise."

³⁸⁰

Cf. Sherwood v. Chan Tze Ngon, C.A. No. 7106-VCP, 2011 Del. Ch. LEXIS 202, at *25 (Del. Ch. Dec. 20, 2011), which involved an action over disclosures about a Board's decision not to renominate a director for election at the company's annual meeting, and in which the Court found that the plaintiff had adequately alleged disclosure claims where the proxy statement suggested that the director's "questionable and disruptive personal behavior was the only reason that motivated the board to remove him from the Company's slate." The Court commented that it is "important that directors be able to register effective dissent" and that "[a] reasonable shareholder likely would perceive a material difference between, on the one hand, an unscrupulous, stubborn and belligerent director as implied by the Proxy Supplement and, on the other hand, a zealous advocate of a policy position who may go to tactless extremes on occasion." *See infra* note 413 and related text.

The *Shocking Technologies* case illustrates the risk that a director takes when he leaks confidential information to achieve his objectives, however laudable he may believe them to be. The case also shows the difficulties corporations face when dealing with directors who will take steps that may damage the corporation to achieve their personal objectives.

Where a Board reasonably concludes that its fiduciary duties to preserve the confidentiality of sensitive information so require, the Board may condition its seating of a director upon the director's signing a confidentiality agreement providing that the individual will maintain the confidentiality of information received as a director and not disclose it to the private equity firm that designated the director pursuant to a contractual right to designate a director.³⁸¹

(7) Candor/Disclosure in Proxy Statements and Prospectuses. Where directors allow their companies to issue deceptive or incomplete communications to their stockholders, the directors can breach their duties of candor and good faith, which are subsets of the fiduciary duty of loyalty:

When a Delaware corporation communicates with its shareholders, even in the absence of a request for shareholder action, shareholders are entitled to honest communication from directors, given with complete candor and in good faith. Communications that depart from this expectation, particularly where it can be shown that the directors involved issued their communication with the knowledge that it was deceptive or incomplete, violate the fiduciary duties that protect shareholders. Such violations are sufficient to subject directors to liability in a derivative claim.

* * *

Although directors have a responsibility to communicate with complete candor in all shareholder communications, those that are issued with respect to a request for shareholder action are especially critical. Where, as here, the directors sought shareholder approval of an amendment to a stock option plan that could potentially enrich themselves and their patron, their concern for complete and

³⁸¹ See *Partners Healthcare Solutions Holdings, L.P. v. Universal American Corp.*, C.A. No. 9593-VCG (Del. Ch. June 17, 2015), in which the Delaware Chancery Court granted summary judgment to defendant Universal American Corp. (“UAM”), rejecting the contentions of one of UAM’s largest stockholders, Partners Healthcare Solutions Holdings (“Partners”), that UAM had breached an agreement entitling Partners to designate an independent director by imposing conditions on the seating of Partners’ designee to the UAM board that were not provided for in the agreement. In *Partners Healthcare*, the UAM Board required the plaintiff Partners’ designee to the Board to sign a confidentiality agreement that provided, among other things, (1) that information learned as a UAM director would be used only in connection with that role, and explicitly that such information would not be used in the fraud litigation brought by Partners against UAM; (2) that the designee would not share non-public information concerning UAM with any third parties, explicitly including the law firm representing Partners in the litigation; and (3) that the designee would only share non-public information with Partners’ employees on a need-to-know basis. In granting UAM’s motion for summary judgment, the Court found that imposing such conditions on the designee was in the faithful discharge of the Board’s fiduciary duties

honest disclosure should make Caesar appear positively casual about his wife's infidelity.³⁸²

In another case, the contours of the duty of candor were further explained:

Generally, directors have a duty to disclose all material information in their possession to shareholders when seeking shareholder approval for some corporate action. This "duty of disclosure" is not a separate and distinct fiduciary duty, but it clearly does impose requirements on a corporation's board. Those requirements, however, are not boundless. Rather, directors need only disclose information that is material, and information is material only "if there is a substantial likelihood that a reasonable stockholder would consider it important in deciding how to vote." It is not sufficient that information might prove helpful; to be material, it must "significantly alter the total mix of information made available." The burden of demonstrating a disclosure violation and of establishing the materiality of requested information lies with the plaintiffs.³⁸³

In *Gantler v. Stephens*, the Delaware Supreme Court addressed duty of candor issues in the context of a proxy statement for a stockholder vote on a going private proposal in which common stock held by small stockholders would be converted by an amendment to the certificate of incorporation into non-voting preferred stock.³⁸⁴ With respect to the plaintiffs' claims that the proxy statement for the reclassification failed to disclose the circumstances of one bidder's withdrawal and insufficient deliberations by the Board before deciding to reject another's bid, the Court wrote:

It is well-settled law that "directors of Delaware corporations [have] a fiduciary duty to disclose fully and fairly all material information within the board's control when it seeks shareholder action." That duty "attaches to proxy statements and any other disclosures in contemplation of stockholder action." The essential inquiry here is whether the alleged omission or misrepresentation is material. The burden of establishing materiality rests with the plaintiff, who must demonstrate "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."

In the Reclassification Proxy, the Board disclosed that "[a]fter careful deliberations, the board determined in its business judgment that the [rejected merger] proposal was not in the best interest of the Company or our shareholders and rejected the [merger] proposal." Although boards are "not required to disclose all available information[,] . . ." "once [they] travel[] down the road of partial disclosure of . . . [prior bids] us[ing] . . . vague language. . . , they ha[ve] an obligation to provide the stockholders with an accurate, full, and fair characterization of those historic events."

³⁸² *In re infoUSA, Inc. S'holders Litig.*, 953 A.2d 963, 1001 (Del. Ch. 2007).

³⁸³ *In re CheckFree Corp.*, No. 3193-CC, 2007 WL 3262188 at *2 (Del. Ch. Nov. 1, 2007).

³⁸⁴ 965 A.2d 695, 710 (Del. 2009).

By stating that they “careful[ly] deliberat[ed],” the Board was representing to the shareholders that it had considered the Sales Process on its objective merits and had determined that the Reclassification would better serve the Company than a merger. * * * [This] disclosure was materially misleading.

The Reclassification Proxy specifically represented that the [company] officers and directors “ha[d] a conflict of interest with respect to the [Reclassification] because he or she is in a position to structure it in a way that benefits his or her interests differently from the interests of unaffiliated shareholders.” Given the defendant fiduciaries’ admitted conflict of interest, a reasonable shareholder would likely find significant—indeed, reassuring—a representation by a conflicted Board that the Reclassification was superior to a potential merger which, after “careful deliberations,” the Board had “carefully considered” and rejected. In such circumstances, it cannot be concluded as a matter of law, that disclosing that there was little or no deliberation would not alter the total mix of information provided to the shareholders.

* * *

We are mindful of the case law holding that a corporate board is not obligated to disclose in a proxy statement the details of merger negotiations that have “gone south,” since such information “would be [n]either viably practical [n]or material to shareholders in the meaningful way intended by . . . case law.” Even so, a board cannot properly claim in a proxy statement that it had carefully deliberated and decided that its preferred transaction better served the corporation than the alternative, if in fact the Board rejected the alternative transaction without serious consideration.³⁸⁵

In *Pfeffer v. Redstone*³⁸⁶ in a shareholder breach of fiduciary duty class action against a corporation’s Board and controlling shareholder after the corporation divested itself of its controlling interest in a subsidiary by means of a special cash dividend followed by an offer to parent company stockholders to exchange their parent stock for subsidiary stock,³⁸⁷ the Delaware Supreme Court explained that it was not a breach of the duty of candor to fail to disclose in the exchange offer prospectus an internal cash flow analysis which showed that the subsidiary would have cash flow shortfalls after the transactions, but which had been prepared by a lower level employee and never given to the Board:

³⁸⁵ *Id.* at 710-11.

³⁸⁶ 965 A.2d 676, 681 (Del. 2009).

³⁸⁷ The Court found the exchange offer to be purely voluntary and non-coercive, and not to require entire fairness review even though it was with the controlling stockholder. Further, since there was no representation that the exchange ratio was fair, there was no duty to disclose the methodology for determining the exchange ratio, as would have been necessary to ensure a balanced presentation if there had been any disclosure to the effect that the exchange ratio was fair. As the exchange offer was non-coercive and voluntary, the parent had no duty to offer a fair price. The prospectus disclosed that the Boards of parent and subsidiary were not making any recommendation regarding whether stockholders should participate in the exchange offer and were not making any prediction of the prices at which the respective shares would trade after the exchange offer expired. 965 A.2d at 689.

For the Viacom Directors to have either misstated or failed to disclose the cash flow analysis in the Prospectus, those directors must have had reasonable access to that Blockbuster information. “To state a claim for breach by omission of any duty to disclose, a plaintiff must plead facts identifying (1) material, (2) reasonably available (3) information that (4) was omitted from the proxy materials.” “[O]mitted information is *material* if a reasonable stockholder would consider it important in deciding whether to tender his shares or would find that the information has altered the ‘total mix’ of information available.” The Viacom Directors must fully and fairly disclose all material information within its control when seeking shareholder action. They are not excused from disclosing material facts simply because the Prospectus disclosed risk factors attending the tender offer. If the Viacom Directors did not know or have reason to know the allegedly missing facts, however, then logically the directors could not disclose them.³⁸⁸

(8) Candor/Disclosure in Business Combination Disclosures. Duty of candor allegations accompany many challenges to business combination transactions in which shareholder proxies are solicited for approval of the transaction. Sometimes the challenges are successful enough to lead the Chancery Court to order the postponement of meeting of shareholders until corrective disclosures are made in proxy materials.³⁸⁹ In other instances, the omissions complained of are found to be immaterial.³⁹⁰

Directors can, and in larger transactions typically do, rely on expert advice in the form of an investment banker’s (“*banker*”) fairness opinion.³⁹¹ These opinions generally state that the merger consideration is “fair” (i.e. within the range of reasonableness) to the target’s stockholders from a financial point of view, and are backed up by a presentation book (“*banker’s book*” or “*board book*”) presented by the banker to the Board containing financial projections and information about comparable transactions. The proxy statement for the transaction typically contains the fairness opinion and a description of how the banker reached its conclusion that the transaction is fair, but not the banker’s book. Litigation frequently ensues in which the proxy

³⁸⁸ *Pfeffer v. Redstone*, 965 A.2d 676, 686-87 (Del. 2009).

³⁸⁹ *See, e.g., Maric Capital Master Fund, Ltd., v. Plato Learning, Inc.*, 11 A.3d 1175, 1176 (Del. Ch. 2010) (merger enjoined until corrective disclosures, including correction of statement that management compensation arrangements were not negotiated prior to signing the merger agreement when, although there may not have been any agreement, the buyer communicated to the CEO that it liked to keep management after its acquisitions and outlined its typical compensation package); *In re Art Technology Group, Inc. Shareholders Litigation*, C.A. No. 5955-VCL, 2010 Del. Ch. LEXIS 257, at *1 (Del. Ch. Dec. 21, 2010) (bench ruling enjoining special meeting of stockholders to vote on merger based on target company’s failure to disclose in its proxy statement the fees that its financial advisor had received from the buyer during the preceding two years in unrelated transactions).

³⁹⁰ *In re Delphi Financial Group Shareholder Litigation*, C.A. No. 7144-VCG, 2012 Del. Ch. LEXIS 45, at *63 (Del. Ch. Mar. 6, 2012), Vice Chancellor Glasscock commented:

In limiting the disclosure requirement to all “material” information, Delaware law recognizes that too much disclosure can be a bad thing. As this Court has repeatedly recognized, “a reasonable line has to be drawn or else disclosures in proxy solicitations will become so detailed and voluminous that they will no longer serve their purpose.” If anything, Delphi’s Proxy is guilty of such informational bloatedness, and not, as the Plaintiffs contend, insufficient disclosure.

³⁹¹ *See supra* note 310, and *infra* notes 427, 751-758.

statement disclosures regarding the banker's process and the underpinnings of the fairness opinion are challenged.³⁹²

The plaintiffs' bar favors duty of candor challenges to mergers because a colorable disclosure claim provides a hook for expedited proceedings and a preliminary injunction.³⁹³ Thus, a "Denny's buffet" of disclosure claims is included in almost every complaint.³⁹⁴ The pressure to get a deal to a shareholder vote results in frequent settlements.³⁹⁵ Despite so much litigation, the law governing disclosure claims remains unsettled.

*Skeen v. Jo-Ann Stores, Inc.*³⁹⁶ remains the seminal Delaware Supreme Court decision on what must be disclosed about a banker's book and related banker analyses. *Skeen* involved a cash-out merger following first-step tender offer. The information statement for the transaction included a copy of the fairness opinion given by target's investment banker, target's audited and unaudited financial statements through the day before signing and the target's quarterly market prices and dividends through the year then ended. Plaintiffs alleged that the information statement should have included, *inter alia*, (i) a summary of "methodologies used and range of values generated" by target's banker, (ii) management's projections of target's financial performance for the next five years, and (iii) more current financial statements. In rejecting plaintiffs' argument that "stockholders [must] be given all the financial data they would need if they were making an independent determination of fair value" and holding that the standard is "substantial likelihood that the undisclosed information would significantly alter the total mix of information already provided," the Supreme Court explained:

Directors of Delaware corporations are fiduciaries who owe duties of due care, good faith and loyalty to the company and its stockholders. The duty of disclosure is a specific formulation of those general duties that applies when the corporation is seeking stockholder action. It requires that directors "disclose fully and fairly all material information within the board's control...." Omitted facts are material "if there is a substantial likelihood that a reasonable stockholder would consider [them] important in deciding how to vote." Stated another way, there must be "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable stockholder as having significantly altered the 'total mix' of information made available."

These disclosure standards have been expressed in much the same language over the past 25 years. In the merger context, the particular stockholder action being solicited usually is a vote, and the oft-quoted language from our cases refers to information the stockholders would find important in deciding how to vote. But the vote, if there is one, is only part of what the stockholders must

³⁹² In 2011 96% of transactions over \$500 million were subject to litigation (up from 53% in 2007), and there was more litigation per deal in 2011 – 6.2 suits per deal in 2011 vs. 2.8 in 2007. Hon. Justice Myron Steele, *Contemporary Issues for Traditional Director Fiduciary Duties*, University of Arizona (August 1, 2012).

³⁹³ Hon. Myron Steele, *supra* note 392.

³⁹⁴ Hon. Myron Steele, *supra* note 392.

³⁹⁵ Hon. Myron Steele, *supra* note 392.

³⁹⁶ 750 A.2d 1170, 1172 (Del. 2000).

decide. Appraisal rights are available in many mergers, and stockholders who vote against the merger also must decide whether to exercise those rights.

* * *

To state a disclosure claim, appellants “must provide some basis for a court to infer that the alleged violations were material....[They] must allege that facts are missing from the [information] statement, identify those facts, state why they meet the materiality standard and how the omission caused injury.” Appellants have not met this pleading requirement. They offer no undisclosed facts concerning the supposed “plan” that would have been important to the appraisal decision.

* * *

Appellants also complain about several alleged deficiencies in the financial data that was disclosed. The Information Statement included a copy of the fairness opinion given by HF’s investment banker, Donaldson, Lufkin & Jenrette (DLJ); the company’s audited and unaudited financial statements through January 31, 1998; and HF’s quarterly market prices and dividends through the year ended January 31, 1998. The complaint alleges that, in addition to this financial information, HF’s directors should have disclosed: (1) a summary of “the methodologies used and ranges of values generated by DLJ” in reaching its fairness opinion; (2) management’s projections of HF’s anticipated performance from 1998 - 2003; (3) more current financial statements; and (4) the prices that HF discussed for the possible sale of some or all of the company during the year prior to the merger.

Appellants allege that this added financial data is material because it would help stockholders evaluate whether they should pursue an appraisal. They point out that the \$4.25 per share merger price is 20% less than the company’s book value. Since book value generally is a conservative value approximating liquidation value, they wonder how DLJ could conclude that the merger price was fair. If they understood the basis for DLJ’s opinion, appellants say they would have a better idea of the price they might receive in an appraisal. Projections, more current financials and information about prices discussed with other possible acquirors, likewise, would help them predict their chances of success in a judicial determination of fair value.

The problem with appellants’ argument is that it ignores settled law. Omitted facts are not material simply because they might be helpful. To be actionable, there must be a substantial likelihood that the undisclosed information would significantly alter the total mix of information already provided. The complaint alleges no facts suggesting that the undisclosed information is inconsistent with, or otherwise significantly differs from, the disclosed information. Appellants merely allege that the added information would be helpful in valuing the company.

Appellants are advocating a new disclosure standard in cases where appraisal is an option. They suggest that stockholders should be given all the financial data they would need if they were making an independent determination of fair value. Appellants offer no authority for their position and we see no reason to depart from our traditional standards. We agree that a stockholder deciding whether to seek appraisal should be given financial information about the company that will be material to that decision. In this case, however, the basic financial data were disclosed and appellants failed to allege any facts indicating that the omitted information was material. Accordingly, the complaint properly was dismissed for failure to state a claim.³⁹⁷

In re Pure Resources, Incorporated Shareholders Litigation,³⁹⁸ the SEC filings contained financial advisor opinions, historical financial information and projections. Chancellor (then Vice Chancellor) Strine addressed whether bankers' underlying financial analyses should be disclosed. The Court observed competing policies against disclosure (fear of "stepping on the

³⁹⁷ *Id.* at 1172-74. In *McMullin v. Beran*, 765 A.2d 910, 925-26 (Del. 2000), the Delaware Supreme Court followed *Skeen* and elaborated as follows:

In properly discharging their fiduciary responsibilities, directors of Delaware corporations must exercise due care, good faith and loyalty whenever they communicate with shareholders about the corporation's affairs. When shareholder action is requested, directors are required to provide shareholders with all information that is material to the action being requested and "to provide a balanced, truthful account of all matters disclosed in the communication with shareholders." The materiality standard requires that directors disclose all facts which, "under all the circumstances, ... would have assumed actual significance in the deliberations of the reasonable shareholder." These disclosure standards are well established.

Earlier this year, we decided another case involving alleged disclosure violations when minority shareholders were presented with the choice of either tendering their shares or being "cashed out" in a third-party merger transaction that had been pre-approved by the majority shareholder. In *Skeen*, it was argued that the minority shareholders should have been given all of the financial data they would need if they were making an independent determination of fair value. We declined to establish "a new disclosure standard where appraisal is an option." We adhere to our holding in *Skeen*.

McMullin's Amended Complaint alleges that the Chemical Directors breached their fiduciary duty by failing to disclose to the minority shareholders material information necessary to decide whether to accept the Lyondell tender offer or to seek appraisal under 8 Del. C. § 262. The Court of Chancery summarized the plaintiff's allegations that the defendants breached their duty of disclosure by omitting from the 14D-9 the following information: indications of interest from other potential acquirers; the handling of these potential offers; the restrictions and constraints imposed by ARCO on the potential sale of Chemical; the information provided to Merrill Lynch and the valuation methodologies used by Merrill Lynch. In a similar context, the Court of Chancery has held the fact that the majority shareholder controls the outcome of the vote on the merger "makes a more compelling case for the application of the recognized disclosure standards."

When a complaint alleges disclosure violations, courts are required to decide a mixed question of fact and law. In the specific context of this case, an answer to the complaint, discovery and a trial may all be necessary to develop a complete factual record before deciding whether, as a matter of law, the Chemical Directors breached their duty to disclose all material facts to the minority shareholders. The disclosure violations alleged in McMullin's Amended Complaint are, if true, sufficient to withstand a motion to dismiss.

³⁹⁸ 808 A.2d 421, 448 (Del. Ch. 2002).

SEC's toes" and worry of "encouraging prolix disclosures") and in favor of disclosure ("utility of such information" and Delaware case law encouraging banker analyses for Board decisions), cited *Skeen* and other cases as manifesting the "conflicting impulses," and concluded that more fulsome disclosure is required:

As their other basis for attack, the plaintiffs argue that neither of the key disclosure documents provided to the Pure stockholders — the S-4 Unocal issued in support of its Offer and the 14D-9 Pure filed in reaction to the Offer — made materially complete and accurate disclosure. The general legal standards that govern the plaintiffs' disclosure claims are settled.

In circumstances such as these, the Pure stockholders are entitled to disclosure of all material facts pertinent to the decisions they are being asked to make. In this case, the Pure stockholders must decide whether to take one of two initial courses of action: tender and accept the Offer if it proceeds or not tender and attempt to stop the Offer. If the Offer is consummated, the non-tendering stockholders will face two subsequent choices that they will have to make on the basis of the information in the S-4 and 14D-9: to accept defeat quietly by accepting the short-form merger consideration in the event that Unocal obtains 90% and lives up to its promise to do an immediate short-form merger or seek to exercise the appraisal rights described in the S-4. I conclude that the S-4 and the 14D-9 are important to all these decisions, because both documents state that Unocal will effect the short-form merger promptly if it gets 90%, and shareholders rely on those documents to provide the substantive information on which stockholders will be asked to base their decision whether to accept the merger consideration or to seek appraisal.

As a result, it is the information that is material to these various choices that must be disclosed. In other words, the S-4 and the 14D-9 must contain the information that "a reasonable investor would consider important in tendering his stock," including the information necessary to make a reasoned decision whether to seek appraisal in the event Unocal effects a prompt short-form merger. In order for undisclosed information to be material, there must be a "substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable stockholder as having significantly altered the 'total mix' of information made available."

The S-4 and 14D-9 are also required "to provide a balanced, truthful account of all matters" they disclose. Related to this obligation is the requirement to avoid misleading partial disclosures. When a document ventures into certain subjects, it must do so in a manner that is materially complete and unbiased by the omission of material facts.

* * *

First and foremost, the plaintiffs argue that the 14D-9 is deficient because it does not disclose *any* substantive portions of the work of First Boston and

Petrie Parlunan on behalf of the Special Committee, even though the bankers' negative views of the Offer are cited as a basis for the board's own recommendation not to tender. Having left it to the Pure minority to say no for themselves, the Pure board (the plaintiffs say) owed the minority the duty to provide them with material information about the value of Pure's shares, including, in particular, the estimates and underlying analyses of value developed by the Special Committee's bankers. This duty is heightened, the plaintiffs say, because the Pure minority is subject to an immediate short-form merger if the Offer proceeds as Unocal hopes, and will have to make the decision whether to seek appraisal in those circumstances.

* * *

This is a continuation of an ongoing debate in Delaware corporate law, and one I confess to believing has often been answered in an intellectually unsatisfying manner. Fearing stepping on the SEC's toes and worried about encouraging prolix disclosures, the Delaware courts have been reluctant to require informative, succinct disclosure of investment banker analyses in circumstances in which the bankers' views about value have been cited as justifying the recommendation of the board. But this reluctance has been accompanied by more than occasional acknowledgement of the utility of such information, an acknowledgement that is understandable given the substantial encouragement Delaware case law has given to the deployment of investment bankers by boards of directors addressing mergers and tender offers.

These conflicting impulses were manifested recently in two Supreme Court opinions. In one, *Skeen v. Jo-Ann Stores, Inc.*, the Court was inclined towards the view that a summary of the bankers' analyses and conclusions was not material to a stockholders' decision whether to seek appraisal. In the other, *McMullin v. Beran*, the Court implied that information about the analytical work of the board's banker could well be material in analogous circumstances.

In my view, it is time that this ambivalence be resolved in favor of a firm statement that stockholders are entitled to a fair summary of the substantive work performed by the investment bankers upon whose advice the recommendations of their board as to how to vote on a merger or tender rely. I agree that our law should not encourage needless prolixity, but that concern cannot reasonably apply to investment bankers' analyses, which usually address the most important issue to stockholders — the sufficiency of the consideration being offered to them for their shares in a merger or tender offer. Moreover, courts must be candid in acknowledging that the disclosure of the banker's "fairness opinion" alone and without more, provides stockholders with nothing other than a conclusion, qualified by a gauze of protective language designed to insulate the banker from liability.

The real informative value of the banker's work is not in its bottom-line conclusion, but in the valuation analysis that buttresses that result. This

proposition is illustrated by the work of the judiciary itself, which closely examines the underlying analyses performed by the investment bankers when determining whether a transaction price is fair or a board reasonably relied on the banker's advice. Like a court would in making an after-the-fact fairness determination, a Pure minority stockholder engaging in the before-the-fact decision whether to tender would find it material to know the basic valuation exercises that First Boston and Petrie Parkman undertook, the key assumptions that they used in performing them, and the range of values that were thereby generated. After all, these were the very advisors who played the leading role in shaping the Special Committee's finding of inadequacy.

In an effort to avoid being delayed by proceedings in the Chancery Court, M&A practice has evolved to reflect a *Pure* standard.³⁹⁹ In *Kahn v. Chell*,⁴⁰⁰ Vice Chancellor Laster commented:

I think it's continuing to be somewhat surprising that despite now years of opinions, particularly from Vice Chancellor Strine, explaining that we expect these things to be disclosed, people don't disclose them. But as I've said in another transcript, what I think that speaks to is the desirability of getting releases as opposed to an actual desire to follow what the Delaware courts have said in terms of what's material information. And so, to the extent that people are consciously or can be inferred to have been consciously leaving things out that are covered by prior decisions, that's something we're going to have to take into account on an ongoing basis; not just me, but obviously my colleagues. But it is something that's somewhat troubling.

Later in *Stourbridge Investments LLC v. Bersoff*,⁴⁰¹ Vice Chancellor Laster commented:

[T]he increase in disclosure-only settlements is troubling. Disclosure claims can be settled cheaply and easily, creating a cycle of supplementation that confers minimal, if any, benefits on the class.

(9) Candor/Disclosure in Notices and Other Disclosures. In *Berger v. Pubco Corp.*,⁴⁰² the Delaware Supreme Court addressed the nature and scope of the remedy available to minority stockholders when a controlling stockholder breaches its duty of disclosure in connection with a short form merger pursuant to DGCL § 253. The 90% stockholder of Pubco (a non-publicly traded Delaware corporation) formed a wholly-owned subsidiary, transferred his Pubco shares to the subsidiary and effected a short form merger under DGCL § 253 in which Pubco's minority stockholders were cashed out. Prior to the merger, Pubco sent a written notice to its stockholders stating that the 90% stockholder intended to effect a short form merger and that the stockholders would be cashed out. The notice included a very short description of

³⁹⁹ See *In re Netsmart Technologies, Inc. Shareholders Litigation*, 924 A.2d 171, 204 (Del. Ch. 2007).

⁴⁰⁰ Transcript (Laster, V.C., June 7, 2011).

⁴⁰¹ Transcript (Laster, V.C., March 13, 2012).

⁴⁰² 976 A.2d 132, 140 (Del. 2009).

Pubco, but failed to include any information regarding its plans, prospects or operations, lumped all of its financial statements together and failed to provide any information about how the cashout price was determined. An outdated version of the Delaware appraisal statute was included with the notice. Plaintiff brought a class action lawsuit on behalf of all of Pubco's minority stockholders to recover the difference between the cashout price and the fair value of the shares based on defendants' failure to provide stockholders with all material information.

In *Pubco*, the Supreme Court agreed with the Court of Chancery that there were disclosure duty failures and that the optimal remedy for disclosure violations in this context is a "quasi-appraisal" action to recover the difference between "fair value" and the merger price. Unlike the Court of Chancery, however, the Supreme Court held that stockholders (i) would be treated automatically as members of the class and continue as members of the class unless and until they opt out after receiving the remedial supplemental disclosure and the notice of class action informing them of their opt-out right, and (ii) would not be required to escrow a portion of the merger proceeds that they already received.

In determining that minority stockholders would not have to opt in, the Supreme Court focused on the respective burdens of the parties. According to the Court, an opt-in requirement would potentially burden stockholders seeking appraisal recovery, who would bear the risk of forfeiture of their appraisal rights, whereas an opt-out requirement would avoid any such risk. To the company, on the other hand, neither option is more burdensome than the other. Under either alternative, "the company will know at a relatively early stage which shareholders are (and are not) members of the class."

The Supreme Court recognized that removing the escrow requirement would provide the stockholders with the dual benefit of retaining merger proceeds while at the same time litigating to recover a higher amount – a benefit they would not have in an actual appraisal. The Court reasoned:

Minority shareholders who fail to observe the appraisal statute's technical requirements risk forfeiting their statutory entitlement to recover the fair value of their shares. In fairness, majority stockholders that deprive their minority shareholders of material information should forfeit their statutory right to retain the merger proceeds payable to shareholders who, if fully informed, would have elected appraisal.⁴⁰³

In *Dubroff v. Wren Holdings, LLC* ("*Dubroff I*"),⁴⁰⁴ the Court of Chancery found that the plaintiffs stated a claim for breach of the fiduciary duty of disclosure in connection with the notice sent to the stockholders pursuant to DGCL § 228⁴⁰⁵ for a recapitalization transaction approved by the written consent of the defendants in which Wren Holdings and the other

⁴⁰³ The Court qualified its opinion by acknowledging that where a "technical and non-prejudicial" violation of DGCL § 253 occurs (*e.g.*, where stockholders receive an incomplete copy of the appraisal statute with their notice of merger), a "quasi-appraisal" remedy with opt-in and escrow requirements might arguably be supportable.

⁴⁰⁴ C.A. No. 3940-VCN, 2009 Del. Ch. LEXIS 89, at *24-26 (Del. Ch. May 22, 2009) ("*Dubroff I*").

⁴⁰⁵ Under DGCL § 228(e) "[p]rompt notice of the taking of the corporate action without a meeting by less than unanimous written consent shall be given to those stockholders ... who have not consented in writing."

defendants (the “*Wren Control Group*”) converted the subordinated debt they held into convertible preferred stock, thereby increasing their ownership of the company’s stock from approximately 56% to 80%, while the remaining stockholders were greatly diluted. After the completion of the recapitalization, the nonconsenting stockholders received a DGCL notice, which provided, in part: “[the company] has recapitalized by converting its outstanding subordinated debt into shares of several new series of convertible preferred stock, and by declaring and implementing a one-four-twenty [sic] reverse stock split on all outstanding shares of common stock of the Company.”⁴⁰⁶ The notice did not, however, inform the stockholders that the defendants were the primary recipients of the new convertible preferred stock; nor did it inform the stockholders of the pricing of the conversion of the defendants’ debt into convertible preferred stock. The plaintiffs argued that they were injured by this lack of disclosure because had the notice contained such information, they could have made a claim for rescissory relief.

The Chancery Court in *Dubroff I* recognized the Delaware case law had not addressed whether notice under DGCL § 228(e) requires a full disclosure akin to that required when stockholder approval is being solicited. While the Court left that inquiry for another time, it did find that regardless of the precise scope of required disclosure, the plaintiffs have stated a claim for breach of fiduciary duty. The Court reasoned that if the requirements under DGCL § 228(e) were akin to a disclosure seeking a stockholder vote (*i.e.*, to disclose all material information), the plaintiffs had pled facts sufficient to establish that the Board materially misled shareholders. If, on the other hand, the disclosure standard is less fulsome in this context, the Court could reasonably infer that the Board deliberately omitted material information with the goal of misleading the plaintiffs and other stockholders about the defendants’ material financial interest in and benefit conferred by the recapitalization. Under Delaware law, whenever directors communicate publicly or directly with stockholders about corporate matters, they must do so honestly. Thus, the Court determined that regardless of the scope of disclosure required pursuant to DGCL § 228(e), the plaintiffs had sufficiently pled a disclosure violation.

Subsequently, the Chancery Court denied a summary judgment motion by the Wren Control Group in the same case (“*Dubroff II*”),⁴⁰⁷ addressing both (i) direct claims of equity dilution (“*equity dilution claims*”) brought by minority stockholders whose equity had been diluted as the result of the recapitalization and (ii) fiduciary duty claims based on the allegedly insufficient disclosures in the DGCL § 228(e) notice. While acknowledging that a controlling stockholder is typically a single person or entity, the Chancery Court noted that under Delaware law a group of stockholders, each of whom cannot individually exert control over the corporation, can collectively form a “*control group*” when those stockholders work together

⁴⁰⁶ *Dubroff I*, 2009 Del. Ch. LEXIS 89, at *22.

⁴⁰⁷ *Dubroff v. Wren Holdings, LLC*, C.A. No. 3940-VCN, 2011 Del. Ch. LEXIS 164, at *24 (Del. Ch. Oct. 28, 2011) (“*Dubroff II*”). *Dubroff II* involved two sets of plaintiffs. One set of plaintiffs, organized by Sheldon Dubroff (the “*Dubroff Plaintiffs*”), first brought a class action in *Dubroff I* on behalf of the company’s former stockholders. The Court in *Dubroff I* refused to certify the Dubroff Plaintiffs’ class action, leaving the Dubroff Plaintiffs to pursue their claims individually. Shortly after the *Dubroff I* opinion was issued, Morris Fuchs and several others (the “*Fuchs Plaintiffs*”), who had acquired roughly 20% of the company’s equity value from 1999 to 2002, filed a complaint similar to the one filed by the *Dubroff I* Plaintiffs. The Fuchs Plaintiffs moved for intervention and consolidation of their case with that of the Dubroff Plaintiffs. *Dubroff II* thus involved two sets of plaintiffs: the Dubroff Plaintiffs and the Fuchs Plaintiffs.

toward a shared goal,⁴⁰⁸ and members of a control group owe fiduciary duties to the minority stockholders of the corporation.⁴⁰⁹ The Chancery Court applied this control group theory in finding that the Wren Control Group acted as a single group to establish the exact terms and timing of the recapitalization, and as a result had control group fiduciary obligations.

In *Dubroff II*, the Chancery Court followed *Gentile v. Rossette*⁴¹⁰ in holding that the plaintiffs could plead direct equity dilution claims because they alleged facts showing that: (1) the Wren Control Group was able to control the corporation and thus were controlling stockholders; (2) the Wren Control Group and the named director defendants were jointly responsible for causing the corporation to issue excessive shares to the Wren Control Group; and (3) the effect of the recapitalization was “an extraction from the corporation’s public stockholders, and a redistribution to [the Wren Control Group], of a substantial portion of the economic portion of the economic value and voting power embodied in the minority interest.”⁴¹¹ The Chancery Court was also critical of earlier Delaware decisions that suggested that if anyone other than the controller benefits from the transaction, then the minority may not assert a direct equity dilution claim. The Court held that as long as the control group’s holdings are not decreased, and the holdings of the minority stockholders are, the latter may have a direct equity dilution claim, even if someone other than the controller also benefits from the transaction.

Although the Chancery Court in *Dubroff II* did not further clarify the requirements of DGCL § 228(e) for a notice to stockholders of the taking of the corporate action without a meeting by less than unanimous consent, the Court did note that whatever the parameters of DGCL § 228(e) may be, the plaintiffs pled sufficient facts for the Court to infer that the Board deliberately omitted material information with the goal of misleading stockholders. The Chancery Court noted that while the notice accurately stated the mechanics of the recapitalization plan, this disclosure alone was not enough because the beneficiaries of and benefits from the recapitalization were not disclosed to stockholders.

In *NACCO Industries, Inc. v. Applica Incorporated*,⁴¹² NACCO (the acquirer under a merger agreement) brought claims against Applica (the target company) for breach of the merger agreement’s “no-shop” and “prompt notice” provisions for assistance it gave to hedge funds managed by Herbert Management Corporation (collectively “*Harbinger*”), which made a topping bid after the merger agreement with NACCO was executed. NACCO also sued Harbinger for common law fraud and tortious interference with contract, alleging that while NACCO and Applica were negotiating a merger agreement, Applica insiders provided confidential information to principals at the Harbinger hedge funds, which were then considering

⁴⁰⁸ *Id.*

⁴⁰⁹ *In re PNB Holding Co. S’holders Litig.*, C.A. No. 28-N, 2006 WL 2403999, at *10 (Del. Ch. Aug. 18, 2006).

⁴¹⁰ 906 A.2d 91, 100 (Del. 2006). While under Delaware law equity dilution claims are typically viewed as derivative, not direct, the Delaware Supreme Court held that certain equity dilution claims may be pled both derivatively and directly in *Gentile v. Rossette*. See *Feldman v. Cutaia*, 956 A.2d 644, 655 (Del. Ch. 2007), and *infra* notes 489-511 and related text.

⁴¹¹ *Dubroff v. Wren Holdings, LLC*, C.A. No. 3940-VCN, 2011 Del. Ch. LEXIS 164, at *24 (Del. Ch. Oct. 28, 2011).

⁴¹² 997 A.2d 1, 6 (Del. Ch. 2009).

their own bid for Applica. During this period, Harbinger amassed a substantial stake in Applica (which ultimately reached 40%), but reported on its Schedule 13D filings that its purchases were for “investment,” thereby disclaiming any intent to control the company. After NACCO signed the merger agreement, communications between Harbinger and Applica management about a topping bid continued. Eventually, Harbinger amended its Schedule 13D disclosures and made a topping bid for Applica, which then terminated the NACCO merger agreement. After a bidding contest with NACCO, Harbinger succeeded in acquiring the company.

The Vice Chancellor also upheld NACCO’s common law fraud claims against Harbinger based on the alleged inaccuracy of Harbinger’s Schedule 13D disclosures about its plans regarding Applica. The Vice Chancellor dismissed Harbinger’s contention that all claims related to Schedule 13D filings belong in federal court, holding instead that a “Delaware entity engaged in fraud”—even if in an SEC filing required by the 1934 Act—“should expect that it can be held to account in the Delaware courts.” The Vice Chancellor noted that while the federal courts have exclusive jurisdiction over violations of the 1934 Act, the Delaware Supreme Court has held that statutory remedies under the 1934 Act are “intended to coexist with claims based on state law and not preempt them.” The Vice Chancellor emphasized that NACCO was not seeking state law enforcement of federal disclosure requirements, but rather had alleged that Harbinger’s statements in its Schedule 13D and 13G filings were fraudulent under state law without regard to whether those statements complied with federal law. The Court then ruled that NACCO had adequately pleaded that Harbinger’s disclosure of a mere “investment” intent was false or misleading, squarely rejecting the argument that “one need not disclose any intent other than an investment intent until one actually makes a bid.” In this respect, the *NACCO* decision highlights the importance of accurate Schedule 13D disclosures by greater-than-5% beneficial owners that are seeking or may seek to acquire a public company and raises the possibility of monetary liability to a competing bidder if faulty Schedule 13D disclosures are seen as providing an unfair advantage in the competition to acquire the company.

In *Sherwood v. Chan*,⁴¹³ the last minute removal of an incumbent director from the company slate shortly before an annual shareholders’ meeting was found to create irreparable harm due to the threat of an uninformed shareholder vote that warranted temporarily enjoining holding the meeting. The Court explained that because considerations to which the business judgment rule applies are not present in the shareholder voting context, the Court does not defer to the judgment of directors about what information is material, and determines materiality for itself from the record at the particular stage of the case when the issue arises. The Court explained the company’s proxy materials may have been misleading in their explanation about the reasons they gave for the removal of the incumbent director from the company’s slate and not nominating him for reelection to the Board. After holding that irreparable harm in the context of a shareholder vote can be established by a mere threat that a shareholder is uninformed, the Court emphasized that:

The corporate election process, if it is to have any validity, must be conducted with scrupulous fairness and without any advantage being conferred or denied to any candidate or slate of candidates. In the interest of corporate democracy, those

⁴¹³ C.A. No. 7106-VCP, 2011 Del. Ch. LEXIS 202, at *25 (Del. Ch. Dec. 20, 2011). *See supra* note 380 and related text.

in charge of the election machinery of a corporation must be held to the highest standards in providing for and conducting corporate elections.

(10) Special Facts Doctrine/Private Company Stock Purchases. *In re Wayport, Inc. Litigation*⁴¹⁴ involved duty of candor and common law fraud claims brought by the founder and former CEO/director of a closely held Delaware corporation headquartered in Austin, Texas against two venture capital funds that were holders of preferred stock of the company, had Board representation and were purchasers of stock from the founder in a privately negotiated transaction. The purchasers knew, but did not disclose, facts related to the company's sale of patents to Cisco for \$7.6 million, an amount sufficient to cause the company's auditors to require disclosure in a note to the company's financial statements and to increase the company's year-end cash position by 22% and represent 77% of its operating income for the year. The patent sale was closed less than a month after a representative of one of the purchasers told the seller, who was concerned whether he was reviewing adequate information from the company and had refused to make a requested representation in the sale agreement that he had received adequate information, that the purchaser was not "aware of any bluebirds of happiness in the Wayport world." The Court interpreted this as a representation that the purchaser was not aware of any material undisclosed information that could affect the value of Wayport's stock. At the time of the "no bluebirds of happiness" statement, the company was in negotiations to sell the patents. After the Board and the purchaser learned of the sale, the "no bluebirds of happiness" statement was not updated.

In rejecting the founder's fiduciary duty claims but sustaining a common law fraud claim, Vice Chancellor Laster explained:

The plaintiffs contended that the defendants owed them fiduciary duties that included a duty to disclose material information when they purchased the plaintiffs' shares. Directors of a Delaware corporation owe two fiduciary duties: care and loyalty. [Citing *Stone v. Ritter*]. The "duty of disclosure is not an independent duty, but derives from the duties of care and loyalty." [Citing *Pfeffer v. Redstone*]. The duty of disclosure arises because of "the application in a specific context of the board's fiduciary duties . . ." * * *

The first recurring scenario is classic common law ratification, in which directors seek approval for a transaction that does not otherwise require a stockholder vote under the DGCL. [Citing *Gantler v. Stephens*]. If a director or officer has a personal interest in a transaction that conflicts with the interests of the corporation or its stockholders generally, and if the board of directors asks stockholders to ratify the transaction, then the directors have a duty "to disclose all facts that are material to the stockholders' consideration of the transaction and that are or can reasonably be obtained through their position as directors." . . . The failure to disclose material information in this context will eliminate any effect that a favorable stockholder vote otherwise might have for the validity of the transaction or for the applicable standard of review. * * *

⁴¹⁴ 76 A.3d 296, 301 (Del. Ch. 2013).

A second and quite different scenario involves a request for stockholder action. When directors submit to the stockholders a transaction that requires stockholder approval (such as a merger, sale of assets, or charter amendment) or which requires a stockholder investment decision (such as tendering shares or making an appraisal election), but which is not otherwise an interested transaction, the directors have a duty to “exercise reasonable care to disclose all facts that are material to the stockholders’ consideration of the transaction or matter and that are or can reasonably be obtained through their position as directors.” * * * A failure to disclose material information in this context may warrant an injunction against, or rescission of, the transaction, but will not provide a basis for damages from defendant directors absent proof of (i) a culpable state of mind or nonexculpated gross negligence, (ii) reliance by the stockholders on the information that was not disclosed, and (iii) damages proximately caused by that failure. * * *

A third scenario involves a corporate fiduciary who speaks outside of the context of soliciting or recommending stockholder action, such as through “public statements made to the market,” “statements informing shareholders about the affairs of the corporation,” or public filings required by the federal securities laws. [Citing *Malone v. Brincat, supra* note 263]. In that context, directors owe a duty to stockholders not to speak falsely:

Whenever directors communicate publicly or directly with shareholders about the corporation’s affairs, with or without a request for shareholder action, directors have a fiduciary duty to shareholders to exercise due care, good faith and loyalty. It follows a *fortiori* that when directors communicate publicly or directly with shareholders about corporate matters the *sine qua non* of directors’ fiduciary duty to shareholders is honesty.

Id. at 10. “[D]irectors who knowingly disseminate false information that results in corporate injury or damage to an individual stockholder violate their fiduciary duty, and may be held accountable in a manner appropriate to the circumstances.” *Id.* at 9; *see id.* at 14 (“When the directors are not seeking shareholder action, but are deliberately misinforming shareholders about the business of the corporation, either directly or by a public statement, there is a violation of fiduciary duty.”). Breach “may result in a derivative claim on behalf of the corporation,” “a cause of action for damages,” or “equitable relief” *Id.*

The fourth scenario arises when a corporate fiduciary buys shares directly from or sells shares directly to an existing outside stockholder. * * * Under the “special facts doctrine” adopted by the Delaware Supreme Court in *Lank v. Steiner*, 224 A.2d 242 (Del. 1966), a director has a fiduciary duty to disclose information in the context of a private stock sale “only when a director is possessed of special knowledge of future plans or secret resources and deliberately misleads a stockholder who is ignorant of them.” * * * If this standard is met, a duty to speak exists, and the director’s failure to disclose

material information is evaluated within the framework of common law fraud. If the standard is not met, then the director does not have a duty to speak and is liable only to the same degree as a non-fiduciary would be.

(Emphasis added)

With the founder's claims under the first three Delaware duty of candor scenarios having been dismissed in prior proceedings,⁴¹⁵ the Court analyzed the founder's claim under the fiduciary duty of disclosure in the direct purchase by a fiduciary as follows:

The legal principles that govern a direct purchase of shares by a corporate fiduciary from an existing stockholder have a venerable pedigree.

As almost anyone who has opened a corporation law casebook or treatise knows, there has been for over a century a conflict of authority as to whether in connection with a purchase of stock a director owes a fiduciary duty to disclose to the selling stockholder material facts which are not known or available to the selling stockholder but are known or available to the director by virtue of his position as a director.

*** Three rules were developed: a majority rule, a minority rule, and a compromise position known as the "special facts doctrine." * * *

The "supposedly 'majority' rule disavows the existence of any general fiduciary duty in this context, and holds that directors have no special disclosure duties in the purchase and sale of the corporation's stock, and need only refrain from misrepresentation and intentional concealment of material facts." * * *

"The ostensibly opposing 'minority' view broadly requires directors to disclose all material information bearing on the value of the stock when they buy it from or sell it to another stockholder." * * *

The special facts doctrine attempts to strike a compromise position between "the extreme view that directors and officials are always under a full fiduciary duty to the shareholders to volunteer all their information and a rule that they are always free to take advantage of their official information." * * * Under this variant, a director has a duty of disclosure only

in special circumstances . . . where otherwise there would be a great and unfair inequality of bargaining position by the use of inside information. Such special circumstances or developments have been held to include peculiar knowledge of directors as to important transactions, prospective mergers, probable sales of the entire assets or business, agreements with third parties to buy large

⁴¹⁵ *Latesco, L.P. v. Wayport, Inc.*, C.A. No. 4167-VCL, 2009 WL 2246793, at *1 (Del. Ch. July 24, 2009).

blocks of stock at a high price and impending declarations of unusual dividends.

* * * Like the minority rule, the compromise position recognizes a duty of disclosure, but cuts back on its scope by limiting disclosure only to that subcategory of material information that qualifies as special facts or circumstances. * * *

After analyzing Delaware precedent, Vice Chancellor Laster concluded that the Delaware Supreme Court follows the “special facts” doctrine and proceeded to analyze the facts thereunder.

Under the “special facts” doctrine, [the funds] were free to purchase shares from other Wayport stockholders, without any fiduciary duty to disclose information about the Company or its prospects, unless the information related to an event of sufficient magnitude to constitute a “special fact.” If they knew of a “special fact,” then they had a duty to speak and could be liable if they deliberately misled the plaintiffs by remaining silent.

To satisfy the “special facts” requirement, a plaintiff generally must point to knowledge of a substantial transaction, such as an offer for the whole company. * * *

Under Delaware law, “[a]n omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important” such that “under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder.” * * * The standard “does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote” or (in more generalized terms) act differently. The standard of materiality is thus lower than the standard for a “special fact.”

* * *

For purposes of Delaware law, the existence of preliminary negotiations regarding a transaction generally becomes material once the parties “have agreed on the price and structure of the transaction.” * * * Under these standards, the plaintiffs did not prove that [an undisclosed proposed licensing] deal ever became material. * * * No agreement on price and structure was reached, and [it] was not otherwise sufficiently firm to be material. It therefore could not rise to the level of a “special fact.”

By contrast, plaintiffs proved at trial that the Cisco sale was material. Wayport and Cisco agreed on a total price of \$9.5 million on June 29, 2007, and the patent sale agreement was signed that day. Wayport’s net sale proceeds of \$7.6 million increased the Company’s year-end cash position by 22%, and the gain on sale represented 77% of the Company’s year-end operating income. Wayport’s auditors concluded that the transaction was material to Wayport’s

financial statements and insisted that it be included over Williams’s opposition because they “really didn’t have an alternative”

The Cisco sale was a milestone in the Company’s process of monetizing its patent portfolio, and it was sufficiently large to enter into the decisionmaking of a reasonable stockholder. But the plaintiffs did not prove at trial that the Cisco sale substantially affected the value of their stock to the extent necessary to trigger the special facts doctrine. * * *

The Court, however, held that the founder had established a claim for fraud by proving (i) a false representation, (ii) a defendant’s knowledge or belief of its falsity or his reckless indifference to its truth, (iii) a defendant’s intention to induce action, (iv) reasonable reliance, and (v) causally related damages.

(b) Care.

(1) Business Judgment Rule; Informed Action; Gross Negligence. The duty of care in Delaware requires a director to perform his duties with such care as an ordinarily prudent man would use in similar circumstances. Subject to numerous limitations, Delaware has a business judgment rule “that a court will not substitute its judgment for that of the Board if the latter’s decision can be ‘attributed to any rational business purpose’.”⁴¹⁶

The availability of the business judgment rule does not mean, however, that directors can act on an uninformed basis. Directors have an obligation to inform themselves of all material information reasonably available to them before making a business decision and, having so informed themselves, to act with the requisite care in making such decision.⁴¹⁷ Directors are not required, however, “to read in haec verba every contract or legal document,”⁴¹⁸ or to “know all particulars of the legal documents [they] authorize[] for execution.”⁴¹⁹

Although a director must act diligently and with the level of due care appropriate to the particular situation, the Delaware courts have held that action (or inaction) will constitute a breach of a director’s fiduciary duty of care only if the director’s conduct rises to the level of gross negligence.⁴²⁰ “Delaware’s current understanding of gross negligence is conduct that constitutes reckless indifference or actions that are without the bounds of reason.”⁴²¹

Compliance with the duty of care requires active diligence. Accordingly, directors should attend board meetings regularly; they should take time to review, digest, and evaluate all materials and other information provided to them; they should take reasonable steps to assure

⁴¹⁶ *Unocal Corp. v. Mesa Petrol. Co.*, 493 A.2d 946, 954 (Del. 1985) (quoting *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971)). See *infra* notes 688-733 and related text.

⁴¹⁷ See *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 367 (Del. 1993) (*Technicolor I*); *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985).

⁴¹⁸ *Van Gorkom*, 488 A.2d at 883 n.25.

⁴¹⁹ *Moran v. Household Int’l, Inc.*, 490 A.2d 1059, 1078 (Del. Ch.), *aff’d*, 500 A.2d 1346 (Del. 1985).

⁴²⁰ See *Van Gorkom*, 488 A.2d at 873.

⁴²¹ *McPadden v. Sidhu*, 964 A.2d 1262, 1274 (Del. Ch. 2008).

that all material information bearing on a decision has been considered by the directors or by those upon whom the directors will rely; they should actively participate in board deliberations, ask appropriate questions, and discuss each proposal's strengths and weaknesses; they should seek out the advice of legal counsel, financial advisors, and other professionals, as needed; they should, where appropriate, reasonably rely upon information, reports, and opinions provided by officers, experts or board committees; and they should take sufficient time (as may be dictated by the circumstances) to reflect on decisions before making them. Action by unanimous written consent ordinarily does not provide any opportunity for, or record of, careful Board deliberations.⁴²²

(2) Business Judgment Rule Not Applicable When Board Conflicted. In *Gantler v. Stephens*, the Delaware Supreme Court held that the business judgment rule was not applicable to the Board's decision to approve a going private stock reclassification proposal in which by amendment to the certificate of incorporation common stock held by smaller stockholders was converted into non-voting preferred stock because the directors were conflicted.⁴²³ The complaint (which the Court accepted as true because the decision was on defendants' motion to dismiss) alleged that the director defendants improperly rejected a value-maximizing merger bid and terminated the sales process to preserve personal benefits, including retaining their positions and pay as directors, as well as valuable outside business opportunities. The complaint further alleged that the Board failed to deliberate before deciding to reject the bid and to terminate the sales process, yet repeatedly disregarded its financial advisor's advice.

The Court noted that “[a] board’s decision not to pursue a merger opportunity is normally reviewed within the traditional business judgment framework,” but:

[T]he business judgment presumption is two pronged. First, did the Board reach its decision in the good faith pursuit of a legitimate corporate interest? Second, did the Board do so advisedly? For the Board’s decision here to be entitled to the business judgment presumption, both questions must be answered affirmatively.

* * *

Here, the plaintiffs allege that the Director Defendants had a disqualifying self-interest because they were financially motivated to maintain the status quo. A claim of this kind must be viewed with caution, because to argue that directors have an entrenchment motive solely because they could lose their positions following an acquisition is, to an extent, tautological. By its very nature, a board decision to reject a merger proposal could always enable a plaintiff to assert that a majority of the directors had an entrenchment motive. For that reason, the plaintiffs must plead, in addition to a motive to retain corporate control, other

⁴²² *Official Comm. of Unsecured Creditors of Integrated Health Serv., Inc. v. Elkins*, C.A. No. 20228, 2004 WL 1949290 at *14 (Del. Ch. Aug. 24, 2004) (discussing how Compensation Committee forgiveness of a loan to the CEO by written consent without any evidence of director deliberation or reliance upon a compensation expert raised a Vice Chancellor’s “concern as to whether it acted with knowing or deliberate indifference.”).

⁴²³ 965 A.2d 695, 705 (Del. 2009).

facts sufficient to state a cognizable claim that the Director Defendants acted disloyally.⁴²⁴

The Delaware Supreme Court found that the plaintiffs had pled facts sufficient to establish disloyalty of at least three (*i.e.*, a majority) of the remaining directors, which sufficed to rebut the business judgment presumption. With respect to the CEO, the Court noted that in addition to losing his long held positions, the plaintiffs alleged a duty of loyalty violation when they pled that the CEO never responded to the due diligence request which had caused one bidder to withdraw its bid and that this bidder had explicitly stated in its bid letter that the incumbent Board would be terminated if it acquired the company. The Court held that it may be inferred that the CEO's unexplained failure to respond promptly to the due diligence request was motivated by his personal financial interest, as opposed to the interests of the shareholders, and that same inference can be drawn from his attempt to "sabotage" another bidder's due diligence request in a similar manner.

Another director was the president of a heating and air conditioning company that provided heating and air conditioning services to the bank; he may have feared that if the company were sold his firm would lose the bank as a client, which to him would be economically significant. A third director was a principal in a small law firm that frequently provided legal services to the company and was also the sole owner of a real estate title company that provided title services in nearly all of the Bank's real estate transactions. In summary, the Delaware Supreme Court concluded the plaintiffs had alleged facts sufficient to establish, for purposes of a motion to dismiss, that a majority of the Board acted disloyally and that a cognizable claim of disloyalty rebuts the business judgment presumption and is subject to entire fairness review.

The Delaware Supreme Court in *Gantler* set forth two reasons for rejecting the Chancery Court's dismissal of the case on the ground that a disinterested majority of the shareholders had "ratified" the reclassification by voting to approve it:

First, because a shareholder vote was required to amend the certificate of incorporation, that approving vote could not also operate to "ratify" the challenged conduct of the interested directors. Second, the adjudicated cognizable claim that the Reclassification Proxy contained a material misrepresentation, eliminates an essential predicate for applying the doctrine, namely, that the shareholder vote was fully informed.

* * *

[T]he scope of the shareholder ratification doctrine must be limited to its so-called "classic" form; that is, to circumstances where a fully informed shareholder vote approves director action that does *not* legally require shareholder approval in order to become legally effective. Moreover, the only director action or conduct that can be ratified is that which the shareholders are specifically asked to approve. With one exception, the "cleansing" effect of such a ratifying

⁴²⁴ *Id.* at 706-07.

shareholder vote is to subject the challenged director action to business judgment review, as opposed to “extinguishing” the claim altogether (*i.e.*, obviating all judicial review of the challenged action).⁴²⁵

(3) Inaction. In many cases, of course, the directors’ decision may be not to take any action. To the extent that decision is challenged, the focus will be on the process by which the decision not to act was made. Where the failure to oversee or to act is so severe as to evidence a lack of good faith, the failure may be found to be a breach of the duty of loyalty.⁴²⁶

(4) Reliance on Reports and Records. The DGCL provides two important statutory protections to directors relating to the duty of care. The first statutory protection is DGCL § 141(e) which provides statutory protection to directors who rely in good faith upon corporate records or reports in connection with their efforts to be fully informed, and reads as follows:

A member of the board of directors, or a member of any committee designated by the board of directors, shall, in the performance of such member’s duties, be fully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation’s officers or employees, or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person’s professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation.⁴²⁷

Members of a Board’s Audit and Risk Management Committee are entitled to rely in good faith on reports and statements and opinions, pursuant to DGCL § 141(e), from the corporation’s officers and employees who are responsible for preparing the company’s financial statements.⁴²⁸ Significantly, as set forth above, DGCL § 141(e) provides protection to directors only if they acted in good faith.

(5) Limitation on Director Liability. The second statutory protection is DGCL § 102(b)(7),⁴²⁹ which allows a Delaware corporation to provide in its certificate of incorporation limitations on (or partial elimination of) director liability for monetary damages in relation to the duty of care.⁴³⁰ The liability of directors may not be so limited or eliminated, however, in connection with breaches of the duty of loyalty, the failure to act in good faith,⁴³¹ intentional

⁴²⁵ *Id.* at 712-13; *see infra* notes 1035-1071 and related text.

⁴²⁶ *See Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006) (holding that “the requirement to act in good faith is a subsidiary element, *i.e.*, a condition, of the fundamental duty of loyalty.”); *see supra* notes 343-358 and related text.

⁴²⁷ DGCL § 141(e). *See infra* notes 555-559 and related text.

⁴²⁸ *In re Citigroup Inc. S’holder Derivative Litig.*, 964 A.2d 106, 135 (Del. Ch. 2009).

⁴²⁹ *See infra* notes 555-559 and related text.

⁴³⁰ *See infra* notes 555-559 and related text.

⁴³¹ *See In re Alloy, Inc. S’holder Litig.*, C.A. No. 5626-VCP, 2011 Del. Ch. LEXIS 159, at *22-23 (Del. Ch. Oct. 13, 2011) (In granting a motion to dismiss a class action challenging a going-private transaction, the Court explained that when a corporation has an exculpatory provision in its charter pursuant to DGCL § 102(b)(7), barring claims for monetary liability against directors for breaches of their duty of care, the

misconduct, knowing violations of law, obtaining improper personal benefits, or paying dividends or approving stock repurchases in violation of DGCL § 174.⁴³²

(c) Aiding and Abetting. A claim for aiding and abetting has four elements: (1) the existence of a fiduciary relationship; (2) a breach of the fiduciary's duty; (3) knowing participation in the breach by the non-fiduciary; and (4) damages proximately caused by the breach.⁴³³ A buyer whose hard negotiations lead to the target's Board making concessions in violation of its fiduciary duties is ordinarily not subject to aider and abettor liability,⁴³⁴ but cannot insist on and incorporate terms that take advantage of a conflict of interest that its fiduciary counterpart faces.⁴³⁵

In *In re Rural/Metro Corp. S'holders Litig.*⁴³⁶ (the "Rural Liability Opinion"), the Delaware Chancery Court held in a post-trial decision that RBC Capital Markets, LLC ("RBC") was liable to a class of stockholders of Rural/Metro Corporation ("Rural") for aiding and abetting breaches of fiduciary duty by the Rural Board. In a subsequent decision the court set the amount of RBC's liability to the class at \$75,798,550.33 (plus interest and after a credit for settlement payments made by two defendants) (the "Rural Damages Opinion").⁴³⁷

The Rural case arose out of a June 30, 2011 merger (the "Rural Merger") in which Rural was acquired by Warburg Pincus LLC ("Warburg") in a transaction that implied an equity value for Rural of \$437.8 million. Lawsuits challenging the Rural Merger were filed shortly after the Rural Merger was announced.

The original complaint named as individual defendants Rural's Board, including Rural's CEO Michael DiMino, and contended that the individual defendants breached their fiduciary duties by (i) making decisions that fell outside the range of reasonableness during the process leading up to the Rural Merger and when approving the Rural Merger (the "Sale Process Claim"), and (ii) by failing to disclose material information in the definitive proxy statement (the "Proxy Statement") that the Company issued in connection with the Rural Merger (the "Disclosure Claim"). Later the plaintiffs filed a second amended complaint that added claims

complaint must state a non-exculpated claim; that is, a claim predicated on a breach of the director's duty of loyalty or bad faith conduct.).

⁴³² DGCL § 102(b)(7); *see also Zirn v. VLI Corp.*, 621 A.2d 773, 783 (Del. 1993) (DGCL § 102(b)(7) provision in corporation's certificate did not shield directors from liability where disclosure claims involving breach of the duty of loyalty were asserted).

⁴³³ *Malpiede v. Townson*, 780 A. 2d 1075, 1096 (Del. 2001).

⁴³⁴ *In re Comverge, Inc. S'holders Litig.*, Consol. C.A. No. 7368-VCP, 2014 WL 6686570, at *19 (Del. Ch. Nov. 25, 2014) (Chancery Court in dismissing aiding and abetting claims against buyer observed that "arm's-length bargaining cannot give rise to aiding and abetting liability on the part of the acquirer."). *See also Lee v. Pincus*, C.A. No. 8458-CB (Del. Ch. Nov. 14, 2014) (Investment bankers were not held liable for aiding and abetting even though they provided their consent to a waiver that allowed certain directors to be given an early release from IPO stock lock-up provisions and thereby sell their shares earlier (and at higher prices) than other stockholders.).

⁴³⁵ *Pontiac Gen. Employees Ret. Sys. v. Ballantine*, C.A. No. 9789-VCL, 2014 WL 6388645 (Del. Ch. Oct. 14, 2014) (TRANSCRIPT)). *See infra* note 983-986 and related text.

⁴³⁶ 88 A.3d 54 (Del. Ch. 2014).

⁴³⁷ *In re Rural/Metro Corp. S'holders Litig.*, 102 A.3d 205, 224 (Del. Ch. Oct. 10, 2014).

against RBC, which acted as Rural's lead financial advisor during the process that led to the Rural Merger, and Moelis & Company, LLC ("*Moelis*"), which served as Rural's secondary financial advisor in a role junior to RBC, and contended that RBC and Moelis aided and abetted the individual defendants in breaching their fiduciary duties.

The events leading up to the Rural Merger began when RBC approached Rural's CEO proposing that Rural consider acquiring American Medical Response ("*AMR*"), a subsidiary of Emergency Medical Services Corporation ("*EMS*") and Rural's lone national competitor in the ambulance business. The Rural Board formed a three-person special committee to generate a recommendation regarding an acquisition of AMR, but at that point did not authorize the special committee to pursue a sale of Rural. The lead director on the special committee was a managing director of a hedge fund which had accumulated 12.43% of the company's stock which represented 22% of the hedge fund's portfolio and, as a successful and overweighted investment, was a position the fund wanted to liquidate. Another committee member needed to reduce the number of Boards on which he served to conform to ISS guidelines, which a sale of Rural could accomplish for him.

The special committee engaged RBC as its primary financial advisor and Moelis as its secondary financial advisor. Although the special committee was not authorized to pursue a sale of Rural at this point, RBC had heard rumors that EMS might be for sale, and believed that a private equity firm that acquired EMS might consider buying Rural rather than selling AMR to Rural. RBC sought to use its position as advisor to Rural to secure buy-side roles with the private equity firms bidding for EMS. Ultimately the special committee authorized RBC and Moelis to explore a sale of Rural contemporaneously with a possible sale of EMS. Although RBC disclosed to the Rural Board its intention to offer staple financing to potential Rural buyers, it did not disclose its plans to use its role as Rural's advisor to secure the financing for the EMS bidders.

After RBC was hired to sell Rural, it encountered problems trying to induce financial buyers to engage in parallel sales processes for Rural and EMS. RBC, Moelis and the special committee contacted twenty-eight private equity firms, but only six firms submitted preliminary bids. Only one submitted a final bid, and this bid did not utilize financing from RBC. The special committee directed RBC and Moelis to enter into final price negotiations with the bidder. RBC continued to seek a buy-side role providing financing to the bidder without disclosing its efforts to the special committee and lowered the valuations of Rural in its fairness presentation to the Rural Board, thereby making the bid look more attractive.

RBC formed an ad hoc fairness committee of two managing directors, which reviewed and approved RBC's fairness opinion. The fairness opinion was subsequently presented to the Rural Board. It was the first valuation information the board received as part of the sale process. The Board approved the Rural Merger. RBC was ultimately unsuccessful in trying to provide financing to the buyer.

The Rural Board and Moelis settled all claims against them for \$6.6 million and \$5 million, respectively. The case proceeded to trial against RBC.

On March 7, 2014, the court issued its Liability Opinion which held, as to the Sale Process Claim, that the Rural directors breached their fiduciary duties by making decisions, taking actions, and allowing steps to be taken that fell outside the range of reasonableness (which the court held was the applicable standard of review). Because the directors had settled their claims, the burden shifted to the plaintiffs to show that the directors' actions were unreasonable. The court held that the provision in Rural's charter exculpating directors for monetary damages arising from breaches of the duty of care did not cover aiders and abettors like RBC.

The court next found that the Rural Board's decisions fell outside the range of reasonableness because (1) running a sales process in parallel with EMS fell outside the range of reasonableness because (i) the special committee had not been authorized to initiate a sale of the company and (ii) RBC did not disclose that proceeding in parallel with the EMS process served its interest in gaining a position in the financing for EMS bidders, and (2) approving the final bid "lacked a reasonable informational basis" because the Board failed (a) to become aware of RBC's last minute maneuvering to secure a role in the buy-side financing; (b) to consider RBC's potentially conflicting incentives; and (c) to receive valuation materials until hours before approving the deal. Next, the court found that RBC knowingly participated in these breaches, by "act[ing] with the knowledge that the conduct advocated or assisted constitute[d] such a breach." The court stated that as advisor to the Board, RBC had obligations to act as "gatekeeper" and to prevent the Board from breaching its fiduciary duty. The court found that RBC had misled the Rural directors into breaching their fiduciary duties by:

- (1) not disclosing its interest in using the Rural sales process to obtain a financing role in an acquisition of EMS;
- (2) not providing any preliminary valuation analysis to the special committee; and
- (3) never disclosing its plans to seek to provide buy-side financing at the end stages of the sales process.

That RBC was not ultimately successful in securing a role in the buy-side financing did not change the court's conclusion.

The court further explained that RBC's conduct in deceiving the Board constituted a "fraud on the board" which rendered RBC equally culpable for the actions of the Board. Finally, the court found that that RBC's actions proximately caused Rural to be sold at a price below its fair value.

As to the Disclosure Claim, the court held that the individual defendants breached their fiduciary duties by providing materially misleading information in the Proxy Statement. The plaintiffs proved at trial that "[i]nformation that RBC provided to the Board in connection with its precedent transaction analyses was false, and that false information was repeated in the Proxy Statement." The court found that information RBC provided about its conflicts of interest was false:

The Proxy Statement stated that RBC received the right to offer staple financing because it "could provide a source for financing on terms that might not otherwise be available to potential buyers of the Company...." This statement was false. The

Board never concluded that RBC could provide financing that might otherwise not be available, and no evidence to that effect was introduced at trial. In December 2010, RBC told the Special Committee that the credit markets were open and receptive to acquisition financing, and they remained so for the duration of the sale process.

The court further found that this statement also constituted a partial disclosure which “imposed on the Rural directors a duty to speak completely on the subject of RBC’s financing efforts.” The Proxy Statement did not describe how RBC used the initiation of the Rural sale process to seek a role in the EMS acquisition financing, did not disclose RBC’s receipt of more than \$10 million for its part in financing the acquisition of EMS, and said nothing about RBC’s lobbying of Warburg after the delivery of Warburg’s fully financed bid while RBC was developing its fairness opinion.

For purposes of the plaintiffs’ claim against RBC for aiding and abetting a breach of duty, the Liability Opinion only needed to determine that the directors’ conduct fell outside the range of reasonableness. The plaintiffs did not ask the court to go further and categorize the defendant directors’ breaches as either breaches of the duty of loyalty or the duty of care.

2.6.5. Officer Fiduciary Duties. Under both Texas and Delaware law, a corporate officer owes fiduciary duties of care and loyalty to the corporation, and may be sued in a corporate derivative action just as a director may be.⁴³⁸ In Texas, “a corporate officer owes a fiduciary duty to the shareholders collectively, i.e., the corporation, but he does not occupy a fiduciary relationship with an individual shareholder unless some contract or special relationship exists between them in addition to the corporate relationship,” and “a corporate shareholder has no individual cause of action for personal damages caused solely by a wrong done to the corporation.”⁴³⁹ The Texas Supreme Court in *Sneed v. Webre*⁴⁴⁰ held that the business judgment rule in Texas protects officers who owe fiduciary duties to the corporation. In *Gantler v. Stephens*, the Delaware Supreme Court held “that officers of Delaware corporations, like directors, owe fiduciary duties of care and loyalty, and that the fiduciary duties of officers are the same as those of directors.”⁴⁴¹

⁴³⁸ *Faour v. Faour*, 789 S.W.2d 620, 621 (Tex. App.—Texarkana 1990, writ denied); *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981); see *Lifshutz v. Lifshutz*, 199 S.W.3d 9, 18 (Tex. App.—San Antonio 2006, pet. denied) (“Corporate officers owe fiduciary duties to the corporations they serve. [citation omitted]. A corporate fiduciary is under a duty not to usurp corporate opportunities for personal gain, and equity will hold him accountable to the corporation for his profits if he does so.”); *Cotten v. Weatherford Bancshares, Inc.*, 187 S.W.3d 687, 698 (Tex. App.—Fort Worth 2006, no pet.) (“While corporate officers owe fiduciary duties to the corporation they serve, they do not generally owe fiduciary duties to individual shareholders unless a contract or confidential relationship exists between them in addition to the corporate relationship.”); see Lyman Johnson & Dennis Garvis, *Are Corporate Officers Advised About Fiduciary Duties?*, 64 BUS. LAW. 1105 (August 2009).

⁴³⁹ *Redmon v. Griffith*, 202 S.W.3d 225, 234 (Tex. App.—Tyler 2006, pet. denied). See *Webre v. Sneed*, 358 S.W.3d 322, 326 (Tex. App.—Houston [1st Dist.] 2011, pet. granted), later proceeding at 2014 Tex. LEXIS 779 (Aug. 29, 2014).

⁴⁴⁰ See *supra* note 298 and related text.

⁴⁴¹ 965 A.2d 695, 709 (Del. 2009). In *Gantler v. Stephens* (an opinion on a motion to dismiss for failure to state a cause of action) allegations that the CEO and Treasurer had breached their fiduciary duty of loyalty by failing to timely provide due diligence materials to two prospective buyers of the company as authorized

For an officer to be held liable for a breach of fiduciary duty, “it will have to be concluded for each of the alleged breaches that [the officer] had the discretionary authority in a relevant functional area and the ability to cause or prevent a complained-of-action.”⁴⁴² Derivative claims against officers for failure to exercise due care in carrying out their responsibilities as assigned by the Board are uncommon.

An individual is entitled to seek the best possible employment arrangements for himself before he becomes a fiduciary, but once the individual becomes an officer or director, his ability to pursue his individual self-interest becomes restricted. *In re The Walt Disney Co. Derivative Litigation*,⁴⁴³ which resulted from the failed marriage between Disney and its former President Michael Ovitz, is instructive as to the duties of an officer.⁴⁴⁴ Ovitz was elected president of Disney on October 1, 1995 prior to finalizing his employment contract, which was executed on December 12, 1995, and he became a director in January 1996. Ovitz’s compensation package was lucrative, including a \$40 million termination payment for a no-fault separation. Ovitz’ tenure as an officer was mutually unsatisfying, and a year later he was terminated on a no-fault basis. Derivative litigation ensued against Ovitz and the directors approving his employment and separation arrangements.

The Delaware Supreme Court affirmed the Chancery Court rulings that (i) as to claims based on Ovitz entering into his employment agreement with Disney, officers and directors become fiduciaries only when they are officially installed and receive the formal investiture of authority that accompanies such office or directorship, and before becoming a fiduciary, Ovitz had the right to seek the best employment agreement possible for himself and (ii) as to claims based on actions after he became an officer: (a) an officer may negotiate his or her own employment agreement as long as the process involves negotiations performed in an adversarial and arms-length manner, (b) Ovitz made the decision that a faithful fiduciary would make by abstaining from attendance at a Compensation Committee meeting [of which he was an ex officio member] where a substantial part of his own compensation was to be discussed and decided upon, (c) Ovitz did not breach any fiduciary duties by executing and performing his employment agreement after he became an officer since no material change was made in it from the form negotiated and approved prior to his becoming an officer, and (d) Ovitz did not breach

by the Board (which led the bidders to withdraw their bids) at a time that the officers were supporting their competing stock reclassification proposal (which the Board ultimately approved over a merger proposal from an unaffiliated third party) were found sufficient to state a claim for breach of the fiduciary duty of loyalty. *See also* *McPadden v. Sidhu*, 964 A.2d 1262, 1263 (Del. Ch. 2008); Megan Wischmeier Shaner, *Restoring the Balance of Power in Corporate Management: Enforcing an Officer’s Duty of Obedience*, 66 BUS. LAW. 27 (Nov. 2010).

⁴⁴² *Pereira v. Cogan*, 294 B.R. 449, 511 (S.D.N.Y. 2003), *vacated on other grounds and remanded*, *Pereira v. Farace*, 413 F.3d 330 (2d Cir. 2005); *see* WILLIAM MEAD FLETCHER ET AL., *FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS*, § 846 (2002) (“The Revised Model Business Corporation Act provides that a non-director officer with discretionary authority is governed by the same standards of conduct as a director.”).

⁴⁴³ 906 A.2d 27, 35 (Del. 2006).

⁴⁴⁴ *See infra* notes 633-640 and related text (discussing *Disney* with respect to director duties when approving executive officer compensation).

any fiduciary duty in receiving no-fault termination payments because he played no part in the determination that he would be terminated or that his termination would not be for cause.⁴⁴⁵

A corporate officer is an agent of the corporation,⁴⁴⁶ and their fiduciary duties are those of an agent as defined in the law of agency.⁴⁴⁷ If an officer commits a tort while acting for the corporation, under the law of agency, the officer is liable personally for his actions.⁴⁴⁸ The corporation may also be liable under *respondeat superior*.

2.6.6. Preferred Stock Rights and Duties.

⁴⁴⁵ See generally *Disney*, 906 A.2d at 35.

⁴⁴⁶ *Joseph Greenspon's Sons Iron & Steel Co. v. Pecos Valley Gas Co.*, 156 A. 350, 351-52 (Del. Super. 1931); *Holloway v. Skinner*, 898 S.W.2d 793, 795 (Tex. 1995). See Lyman Johnson, *Having the Fiduciary Duty Talk: Model Advice for Corporate Officers (and Other Senior Agents)*:

In thirty-four states there are both statutory and common law sources for officer fiduciary duties. The remaining sixteen states [including Delaware and Texas] have only common law. The primary common law source is the law of agency—officers being agents—and the recent *Restatement (Third) of Agency* (“*Restatement*”) is the most authoritative and thorough source of agency law principles. * * *

[T]he *Restatement* states explicitly that an agent’s duty of loyalty is a “fiduciary duty.” Interestingly, however, the *Restatement* describes the agent’s duties of care, competence, and diligence as “performance” duties, deliberately avoiding the descriptor of “fiduciary,” while noting, however, that other sources do refer to such duties as fiduciary in nature. Also, the *Restatement* establishes as the standard applicable to the duties of care, competence, and diligence that level of conduct “normally exercised by agents in similar circumstances.”

* * *

Finally, the *Restatement* states that a “general or broad” advance release of an agent from the agent’s “general fiduciary obligation to the principal [i.e., the duty of loyalty] is not likely to be enforceable.” As to the duties of care, competence, and diligence, however, the *Restatement* states that a “contract may, in appropriate circumstances, raise or lower the standard” applicable to those duties and that such duties can be “contractually shaped,” but it does not indicate whether they can be eliminated altogether.

63 Bus. LAW 147, 148-151 (Nov. 2007).

⁴⁴⁷ See *Webre v. Sneed*, 358 S.W.3d 322, 326 (Tex. App.—Houston [1st Dist.] 2011, pet. granted), later proceeding at 2014 Tex. LEXIS 779 (Aug. 29, 2014); *Redmon v. Griffith*, 202 S.W.3d 255, 234 (Tex. App.—Tyler 2006, pet. denied); *Faour v. Faour*, 789 S.W.2d 620, 621-22 (Tex. App.—Texarkana 1990, writ denied).

⁴⁴⁸ In affirming a Bankruptcy Court holding that a corporate officer personally committed common law fraud in order to obtain a subcontract for the corporation and thus, was personally liable for the debt under Texas common law, which holds a corporate agent personally liable for his misrepresentations made on behalf of the corporation, the Fifth Circuit wrote:

Texas courts have routinely found that “a corporate officer may not escape liability where he had direct, personal participation in the wrongdoing, as to be the ‘guiding spirit behind the wrongful conduct or the central figure in the challenged corporate activity.’” In this case, [the officer], as a corporate agent, may be held “individually liable for fraudulent or tortuous acts committed while in the service of [his] corporation.”

In re Morrison, 555 F.3d 473, 481 (5th Cir. 2009) (citations omitted).

See Dana M. Muir & Cindy A. Schipani, *The Intersection of State Corporation Law and Employee Compensation Programs: Is it Curtains for Veil Piercing?*, 1996 U. ILL. L. REV. 1059, 1078-79 (1996).

(a) Nature of Preferred Stock. Preferred stock is stock which has certain rights and preferences over other classes and series of stock as set forth in the certificate of incorporation, typically by a certificate of designation filed with the Secretary of State to establish the rights of the class or series. The rights, powers, privileges and preferences of preferred stock are generally contractual in nature⁴⁴⁹ and are governed by the express provisions of the certificate of incorporation⁴⁵⁰ of the issuer.⁴⁵¹ The preferential rights, powers or privileges must be “expressly and clearly stated” and “will not be presumed or implied.”⁴⁵² When construing preferred stock provisions, standard rules of contract interpretation are applied to determine the intent of the parties.⁴⁵³ The certificate of incorporation is read as a whole and, to the extent possible, in a manner that permits a reconciliation of all of its provisions.⁴⁵⁴ The implied contractual duty of good faith and fair dealing is applicable to preferred stock.⁴⁵⁵

(b) Generally No Special Fiduciary Duty to Preferred Stock. A preferred stockholder’s preferential rights generally are protected only contractually, whereas the rights that are shared by both preferred stockholders and common stockholders have the benefit of director fiduciary duties.⁴⁵⁶ Preferred stockholders are entitled to share the benefits of the

⁴⁴⁹ C. Stephen Bigler & Jennifer Veet Barrett, *Words that Matter: Considerations in Drafting Preferred Stock Provisions*, ABA Bus. Law Today (Jan. 2014), available at http://www.americanbar.org/publications/blt/2014/01/04_bigler.html.

⁴⁵⁰ When filed with the Secretary of State, a certificate of designation amends the certificate of incorporation and, as a result, the rights of the preferred stockholders become part of the certificate of incorporation. TBCA art. 2.13; TBOC § 21.156; DGCL § 151(g). Thus, a reference by the court to the certificate of incorporation also refers to the certificate of designation, which has been integrated into that certificate. *Elliott Associates, L.P. v. Avatex Corp.*, 715 A.2d 843, 854 n. 3 (Del. 1998). See also *Fletcher International Ltd. v. Ion Geophysical Corp.*, C.A. No. 5109-VCS, 2011 Del. Ch. LEXIS 53, at *2 (Del. Ch. March 29, 2011) (Although a preferred stockholder may attempt to bargain for rights prohibiting the parent company from selling shares of its subsidiaries to third parties without first obtaining the preferred stockholder’s consent, where “[t]he preferred stockholder could have, but did not, bargain for broader rights” protecting its interest; the preferred stockholder cannot expect a court to, “by judicial action, broaden the rights obtained by a preferred stockholder at the bargaining table....; [w]hen sophisticated parties in commerce strike a clear bargain, they must live with its terms;” “a preferred stockholder’s rights are contractual in nature” and “are to be strictly construed and must be expressly contained in the relevant certificates”).

⁴⁵¹ *Elliott Assocs., L.P. v. Avatex Corp.*, 715 A.2d 843, 854 n. 46 (Del. 1998); *Wood v. Coastal States Gas Corp.*, 401 A.2d 932, 937 (Del. 1979); *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 593 (Del. Ch. 1986).

⁴⁵² *Elliott Associates, L.P. v. Avatex Corp.*, 715 A.2d 843, 852-53 (Del. 1998).

⁴⁵³ *Kaiser Alum. Corp. v. Matheson*, 681 A.2d 392, 395 (Del. 1996). See also *ThoughtWorks, Inc. v. SV Investment Partners, LLC*, 902 A.2d 745 (Del. Ch. 2006); *Citadel Holding Corp. v. Roven*, 603 A.2d 818, 822 (Del. 1992).

⁴⁵⁴ *Warner Communications, Inc. v. Chris-Craft Indus., Inc.*, 583 A.2d 962, 967 (Del Ch. 1989), *aff’d*, 567 A.2d 419 (Del 1989). See also *Sonitrol Holding Co. V. Marceau Investissements*, 607 A.2d 1177, 1184 (Del. 1992).

⁴⁵⁵ *Quadrangle Offshore (Cayman) LLC v. Kenetech Corporation*, No. 16362-NC, 1999 WL 893575, at *1 (Del. Ch. Oct. 13, 1999), *aff’d*, 751 A. 2d 878 (Del. Supr. 2000) (“As with all contracts, however, the rights and obligations expressed in the certificate [of designation] are protected by an implied covenant of good faith and fair dealing. . . . [which] plays a narrow but necessary role, prohibiting opportunistic conduct that defeats the purpose of the agreement and runs counter to the justified expectations of the other party.”).

⁴⁵⁶ *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 594 (Del. Ch. 1986).

fiduciary duties of care and loyalty.⁴⁵⁷ One commentator has noted that the only situation in which courts regularly apply fiduciary standards in evaluating preferred stockholders' rights is when their equity stake in the corporation is threatened by corporate control transactions involving interested directors or a controlling stockholder and, even then, only in limited circumstances.⁴⁵⁸ Where the interests of preferred and common shareholders conflict, one court held that the presumption of sound business judgment will be upheld if the Board can attribute its action to any rational business purpose.⁴⁵⁹

(c) Conflicting Interests of Common and Preferred in M&A Transaction. A corporation's common and preferred stockholders may have conflicting interests, particularly if its financial condition deteriorates as in the context of a recapitalization or sale of the business.⁴⁶⁰ For example, *Equity-Linked Investors, L.P. v. Adams*⁴⁶¹ involved a conflict between the interests of the common stockholders and those of the preferred stockholders of Genta Corporation. Genta was on the "lip of insolvency" and in liquidation likely would have been worth substantially less than the \$30,000,000 liquidation preference held by the preferred stock. Rather than preserving what capital remained for distribution to the preferred stock in an immediate liquidation, the Genta Board pursued means to keep the enterprise in operation based in part on a belief that it had several promising technologies in the research stage that, if brought to market, could be extremely valuable. The Chancery Court held that, although the "board action was taken for the benefit largely of the common stock" and the holders of the preferred stock disapproved, it did not constitute a breach of duty to the preferred. The Court based its decision in part on the fact that the special protections afforded to the preferred were contractual in nature. The Court held that where the "foreseeable financial effects of a board decision may importantly fall upon creditors as well as holders of common stock, as where the corporation is in the vicinity of insolvency, an independent board may consider impacts upon all corporate constituencies in exercising its good faith business judgment for benefit of the corporation." The Court essentially allowed the Genta Board to focus on maximizing the corporation's long-term wealth creating capacity even where the business judgment of another Board might have led Genta to liquidate. The Court emphasized, among other things, that the Genta Board (i) was independent; (ii) acted

⁴⁵⁷ *Jackson Nat'l Life Insur. v. Kennedy*, 741 A.2d 377, 387-389 (Del. Ch. 1999).

⁴⁵⁸ Lawrence E. Mitchell, *The Puzzling Paradox Of Preferred Stock (And Why We Should Care About It)*, 51 BUS. LAW. 443 (Feb. 1996); see *Baron v. Allied Artists Pictures Corp.*, 337 A.2d 653, 658 (Del. Ch. 1975) (preferential rights are contractual and are to be strictly construed, but the right of the preferred stockholders to receive cumulative dividends is to be viewed through the prism of fiduciary duties); but see *Security National Bank v. Peters, Writer & Christenson, Inc.*, 569 P.2d 875, 880-82 (Colo. Ct. App. 1977) (holding under Colorado law that the Board breached its fiduciary duties to the preferred shareholders and committed constructive fraud by refusing to sell some securities issued by a third party and held by the corporation in order to use the proceeds to fund the issuer's redemption obligation in respect of its preferred stock, even where the refusal to sell the securities was based upon the Board's belief that the securities would appreciate in value to the benefit of the corporation's common shareholders).

⁴⁵⁹ Where the preferred shareholders of T.I.M.E.-DC, Inc. objected to the spin-off of a corporate subsidiary to the common shareholders of T.I.M.E.-DC, the Court strictly construed the wording of the certificate of incorporation, which did not prohibit the spin off, and held that the spin-off did not violate any fiduciary duty to preferred shareholders. *Robinson v. T.I.M.E.-DC, Inc.*, 566 F. Supp. 1077, 1084 (N.D. Tex. 1983) (citing *Sinclair Oil Corporation v. Levien*, 280 A.2d 717, 720 (Del. 1971)).

⁴⁶⁰ Mark A. Morton, *First Principles for Addressing the Competing Interests of Common and Preferred Stockholders in an M&A Transaction* (Sept. 2009).

⁴⁶¹ 705 A.2d 1040, 1041 (Del. Ch. 1997).

in good faith; (iii) was well-informed regarding the available alternatives to the financial restructuring plan it undertook; and (iv) acted in a manner reasonably related to its business plan. The Court also noted that Genta “would have been” insolvent if the liquidation preference of the preferred stock had been treated as a liability, which indicates that the Court did not consider the liquidation preference of the preferred stock as debt.⁴⁶²

Board ties to one class of stock can result in judicial scrutiny. For example, in *In re Trados Incorporated Shareholder Litigation*,⁴⁶³ the plaintiff alleged that, in determining to pursue a merger and in approving a merger with SDL plc pursuant to which the venture capital (“VC”) preferred stockholders and management received all of the merger consideration and the common stockholders received nothing,⁴⁶⁴ the Trados Board breached its duty of loyalty by improperly favoring the interests of the preferred stockholders. The plaintiff, who owned 5% of the common stock, contended that a majority of the Board was interested or lacked independence when approving the merger and that the conflicted directors improperly favored the interests of the preferred stockholders. Based on the plaintiff’s allegations that a majority of the directors had employment or ownership relationships with the preferred stockholders and depended on the preferred stockholders for their livelihood,⁴⁶⁵ the Court held that the plaintiff sufficiently rebutted the presumption of the business judgment rule (and therefore the burden would shift to the defendants to demonstrate the entire fairness of the transaction) and denied the defendants’ motion to dismiss. The Chancery Court in *Trados I* explained its decision as follows:

Plaintiff contends that this transaction was undertaken at the behest of certain preferred stockholders that desired a transaction that would trigger their large liquidation preference and allow them to exit their investment in Trados. Plaintiff alleges that the Trados board favored the interests of the preferred stockholders, either at the expense of the common stockholders or without properly considering the effect of the merger on the common stockholders. Specifically, plaintiff alleges that the four directors designated by preferred stockholders had other relationships with preferred stockholders and were incapable of exercising disinterested and independent business judgment. Plaintiff further alleges that the two Trados directors who were also employees of the Company received material personal benefits as a result of the merger and

⁴⁶² *Quadrangle Offshore (Cayman) LLC v. Kenetech Corporation*, No. 16362-NC, 1999 WL 893575, at *1 (Del. Ch. Oct. 13, 1999), *aff’d*, 751 A. 2d 878 (Del. Supr. 2000) (“As with all contracts, however, the rights and obligations expressed in the certificate [of designation] are protected by an implied covenant of good faith and fair dealing. . . . [which] plays a narrow but necessary role, prohibiting opportunistic conduct that defeats the purpose of the agreement and runs counter to the justified expectations of the other party.”).

⁴⁶³ No. 1512-VCL, 2009 WL 2225958, at *1 (Del. Ch. July 24, 2009) (“*Trados I*”).

⁴⁶⁴ Of the \$60 million merger consideration, approximately \$52.2 million went to the preferred stockholders (who had a liquidation preference of \$57.9 million) and approximately \$7.8 million went to participants in a management incentive plan (“MIP”) which offered management a percentage of the deal consideration prior to any payment to the preferred or common stock. No consideration was paid to the holders of the common stock in the merger.

⁴⁶⁵ Trados had a seven person Board that included two individuals who were participants in the MIP and three designees of VC firms that held preferred stock. The Board approved the sale without forming a special committee and without obtaining a fairness opinion.

were therefore also incapable of exercising disinterested and independent business judgment.

* * *

Count I of the Complaint asserts a claim that the director defendants breached their fiduciary duty of loyalty to Trados' common stockholders by approving the merger. Plaintiff alleges that there was no need to sell Trados at the time because the Company was well-financed, profitable, and beating revenue projections. Further, plaintiff contends, "in approving the Merger, the Director Defendants never considered the interest of the common stockholders in continuing Trados as a going concern, even though they were obliged to give priority to that interest over the preferred stockholders' interest in exiting their investment."

* * *

A director is interested in a transaction if "he or she will receive a personal financial benefit from a transaction that is not equally shared by the stockholders" or if "a corporate decision will have a materially detrimental impact on a director, but not on the corporation and the stockholders." The receipt of any benefit is not sufficient to cause a director to be interested in a transaction. Rather, the benefit received by the director and not shared with stockholders must be "of a sufficiently material importance, in the context of the director's economic circumstances, as to have made it improbable that the director could perform her fiduciary duties ... without being influenced by her overriding personal interest...."

"Independence means that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences." At this stage, a lack of independence can be shown by pleading facts that support a reasonable inference that the director is beholden to a controlling person or "so under their influence that their discretion would be sterilized."

Plaintiff's theory of the case is based on the proposition that, for purposes of the merger, the preferred stockholders' interests diverged from the interests of the common stockholders. Plaintiff contends that the merger took place at the behest of certain preferred stockholders, who wanted to exit their investment. Defendants contend that plaintiff ignores the "obvious alignment" of the interest of the preferred and common stockholders in obtaining the highest price available for the company. Defendants assert that because the preferred stockholders would not receive their entire liquidation preference in the merger, they would benefit if a higher price were obtained for the Company. Even accepting this proposition as true, however, it is not the case that the interests of the preferred and common stockholders were aligned with respect to the decision of whether to pursue a sale of the company or continue to operate the Company without pursuing a transaction at the time.

The merger triggered the \$57.9 million liquidation preference of the preferred stockholders, and the preferred stockholders received approximately \$52 million dollars as a result of the merger. In contrast, the common stockholders received nothing as a result of the merger, and lost the ability to ever receive anything of value in the future for their ownership interest in Trados. It would not stretch reason to say that this is the worst possible outcome for the common stockholders. The common stockholders would certainly be no worse off had the merger not occurred.

Taking, as I must, the well-pleaded facts in the Complaint in the light most favorable to plaintiff, it is reasonable to infer that the common stockholders would have been able to receive some consideration for their Trados shares at some point in the future had the merger not occurred. This inference is supported by plaintiff's allegations that the Company's performance had significantly improved and that the Company had secured additional capital through debt financing. Thus, it is reasonable to infer from the factual allegations in the Complaint that the interests of the preferred and common stockholders were not aligned with respect to the decision to pursue a transaction that would trigger the liquidation preference of the preferred and result in no consideration for the common stockholders.

Generally, the rights and preferences of preferred stock are contractual in nature. This Court has held that directors owe fiduciary duties to preferred stockholders as well as common stockholders where the right claimed by the preferred "is not to a preference as against the common stock but rather a right shared equally with the common." Where this is not the case, however, "generally it will be the duty of the board, where discretionary judgment is to be exercised, to prefer the interests of common stock—as the good faith judgment of the board sees them to be—to the interests created by the special rights, preferences, *etc.*, of preferred stock, where there is a conflict." Thus, in circumstances where the interests of the common stockholders diverge from those of the preferred stockholders, it is *possible* that a director could breach her duty by improperly favoring the interests of the preferred stockholders over those of the common stockholders. * * *.

Plaintiff has alleged facts that support a reasonable inference that ... the four board designees of preferred stockholders, were interested in the decision to pursue the merger with SDL, which had the effect of triggering the large liquidation preference of the preferred stockholders and resulted in no consideration to the common stockholders for their common shares. Each of these four directors was designated to the Trados board by a holder of a significant number of preferred shares. While this, alone, may not be enough to rebut the presumption of the business judgment rule, plaintiff has alleged more. Plaintiff has alleged that ... each had an ownership or employment relationship with an entity that owned Trados preferred stock. ... Plaintiff further alleges that each of these directors was dependent on the preferred stockholders for their livelihood. As detailed above, each of these entities owned a significant number

of Trados' preferred shares, and together these entities owned approximately 51% of Trados' outstanding preferred stock. The allegations of the ownership and other relationships of each of ... to preferred stockholders, combined with the fact that each was a board designee of one of these entities, is sufficient, under the plaintiff-friendly pleading standard on a motion to dismiss, to rebut the business judgment presumption with respect to the decision to approve the merger with SDL.

In a post-trial hearing, the Court of Chancery held in *Trados II* that the Board's approval of the merger in which Trados' common stockholders received nothing was entirely fair despite the merger having been approved as part of an unfair process in which the interests of the preferred stockholders were favored over the holders of the common stock.⁴⁶⁶ The Court in *Trados II* found that when the interests of the common stock and preferred stock diverge, generally it will be the duty of the Board to prefer the interests of the common stock to those of the preferred. The Court, however, did not state that, when those interests diverge, it would be the duty of the Board to exploit the preferred and did not suggest that the Board had a duty to recut the preferences of the preferred stock to provide some value for the common stock.⁴⁶⁷

In reviewing the plaintiff's fiduciary duty claims under the entire fairness standard of review in *Trados II*, the Court focused on the two elements of an entire fairness review: fair dealing and fair price. As to fair dealing, the Court found that the Board dealt unfairly with the common when negotiating and structuring the merger. The Court in *Trados II* focused on two components of the sale process as evidence of an unfair process. One was the MIP, which raised two concerns: (1) the MIP contained a cut-back feature whereby the management team gave up all benefits from its other equity holdings, including common stock and options to acquire common stock, to the extent of any payments under the MIP, which effectively "converted the management team from holders of equity interests aligned with the common stock to claimants whose return profile and incentives closely resembled those of the preferred," and (2) the MIP was disproportionately funded by the common stockholders. Although with a liquidation preference of \$57.9 million and the MIP taking the first \$7.8 million, the preferred stockholders received \$52.2 million instead of their full liquidation preference (a reduction of nearly 10%), the common stockholders, who in the absence of the MIP would have received \$2.1 million, instead received zero, a reduction of 100%. The Board apparently did not evaluate whether the \$2.1 million of consideration above the liquidation preference should have been allocated to the MIP ahead of the common stockholders from the perspective of the common stockholders.

Another evidentiary component of the unfair process holding was the absence in the record of any meaningful consideration by the Board of the interests of the common stockholders during the Board's evaluation of the proposed merger or alternatives to the funding allocation for

⁴⁶⁶ *In re Trados Inc. Shareholder Litig.*, C.A. No. 1512-VCL, 2013 WL 4511262, at *9 (Del. Ch. Aug. 16, 2013) ("*Trados II*").

⁴⁶⁷ In dicta, the Court noted in *Trados II* that it may be possible to circumvent, through *ex ante* planning, the tension between preferred stockholders and common stockholders, and the attendant heightened standard of review in Delaware, by mechanisms meant to avoid implicating the Board's fiduciary duties, such as building into a company's charter or a stockholders agreement an affirmative right for the preferred stockholders to cause a sale of the whole company without the need for Board approval (such as by implementing drag-along rights).

the MIP as between the preferred stock and the common stock. The Board did not employ any procedural protections for the holders of common stock such as a special committee of directors independent from the preferred stockholders, a fairness opinion from an investment banker engaged by the special committee or a vote of a majority of the stockholders unaffiliated with the holders of the preferred stock. While it acknowledged that these procedural protections were not required, especially given the size of the company and the cost of the measures, the Court in *Trados II* noted that the absence of a majority of the minority vote condition precluded the directors from having an affirmative defense to claims the process was unfair.

The Court, however, found that, at the time the interested Board majority approved the merger, the common stock had no economic value, and Trados did have a realistic chance of building value at a rate that would exceed the dividend rate and thus yield any value for the common stock. The holders of the preferred stock had no duty to continue to fund Trados, and Trados had no realistic prospect of raising funds from other sources to fund its business plan. Effectively holding that the interested directors had no duty to continue to operate the company independently to generate value for the common stock, the Court held that the approval of a merger in which the holders of common stock received no consideration did not constitute a breach of fiduciary duty in this case, and explained in *Trados II*:

The directors breached no duty to the common stock by agreeing to a Merger in which the common stock received nothing. The common stock had no economic value before the Merger, and the common stockholders received in the Merger the substantial equivalent in value of what they had before.

Under the circumstances of this case, the fact that the directors did not follow a fair process does not constitute a separate breach of duty. * * * On these facts, such a finding is not warranted. The defendants' failure to deploy a procedural device such as a special committee resulted in their being forced to prove at trial that the Merger was entirely fair. Having done so, they have demonstrated that they did not commit a fiduciary breach.

The Court also found that the appraised value of the common stock for purposes of the appraisal proceeding was likewise zero because "Trados had no realistic chance of growing fast enough to overcome the preferred stock's existing liquidation preference and 8% cumulative dividend."

Similar to *Trados II*, *In re Nine Systems Corp. Shareholders Litigation*,⁴⁶⁸ the Court of Chancery held that a control group of venture group stockholders and their director designees breached their fiduciary duties in approving a recapitalization of Nine Systems Corporation because the recapitalization was the result of an unfair process, even though it was accomplished at a fair price. As a result of prior financings, three investors owned a combined 54% of the closely held company's equity and over 90% of its senior debt. The designees of those investors, along with the CEO, represented four out of five seats on the Board, and there was one

⁴⁶⁸ Consol. C.A. No. 3940-VCN (Del. Ch. Sept. 4, 2014); see Jeffrey R. Wolters, *Private Company Financings: Delaware Court Provides Guidance for Boards and Venture Funds*, Business Law Today (October 2014).

independent director. The company needed a “reset” of its capital structure, along with additional funds to pursue its business plan (which included acquiring two businesses). In the recapitalization, two of the three existing investors agreed to invest additional funds so that the company could remain a going concern. The Board did not obtain any independent valuation of the company in connection with the recapitalization, and relied on “back of the envelope” calculations performed by one of the investors.

The Court found that the directors breached their fiduciary duties by following an unfair process, evidenced by such factors as the failure to hire an independent financial advisor, the Board’s ignorance of how the recapitalization valuation was derived, and the Board’s failure to obtain input from the one independent director, when it might have cleansed the process by using him as a special committee of one. In doing so, the Court stated that *Trados II* does not stand “for the broad proposition that a finding of fair price, where a company’s common stock had no value, forecloses a conclusion that the transaction was not entirely fair”; rather, the Court stated *Trados II* “reinforces the defining principle of entire fairness – that a court’s conclusion is *contextual*.” However, because it found the price was fair, the court did not award damages.

In *Oliver v. Boston University*,⁴⁶⁹ the Chancery Court found that the plaintiffs established a breach of the Board’s duty of loyalty and required the defendant directors to demonstrate the entire fairness of the Board’s allocation of merger consideration between holders of common and preferred stock. In *Oliver*, the Board was comprised of individuals tied to the preferred stock who treated the merger allocation negotiations with a “surprising degree of informality.” Although representatives of all the preferred stockholders were involved in the negotiations, the Board took no steps (such as permitting a representative of the minority common stockholders to participate in negotiations on their behalf) “to ensure fairness to the minority common shareholders.” For that reason, the Court held that the defendants failed to carry their burden to demonstrate the fairness of the transaction to the holders of common stock.

The Board’s duty of loyalty may be implicated if a majority of the directors own common stock and approve a transaction favoring the common stock over the preferred stock. In *Sullivan Money Mgmt., Inc. v. FLS Holdings, Inc.*,⁴⁷⁰ the Court found that the plaintiffs established a claim for breach of the Board’s duty of loyalty when no independent agency or advisor was appointed to represent the interests of the preferred stockholders during merger negotiations. The plaintiffs alleged that the directors owned large amounts of common stock, that the interests of the common stockholders were in conflict with the interests of the preferred stock in effectuating the merger, and that the defendant directors failed to employ an independent representative to protect the interests of the preferred stock. Under those circumstances, the Court found that the burden shifted to the defendant directors to demonstrate the fairness of the transaction to the holders of preferred stock.

In each of these cases, the Court focused on the inherent conflict of a majority of the Board and the absence of appropriate procedural protections for the stockholders exposed to the potential abuses that may arise out of such conflict. These decisions suggest the use of a special committee of independent directors, a majority of minority stockholder vote, allowing a

⁴⁶⁹ C.A. No. 16570, 2006 WL 1064169, at *27 (Del. Ch. Apr. 14, 2006).

⁴⁷⁰ C.A. No. 12731, 1992 WL 345453, at *1 (Del. Ch. Nov. 20, 1992), *aff’d*, 628 A.2d 84 (Del. 1993).

representative of the minority interest to participate directly in the negotiations concerning allocation, or other procedures to insulate the transaction from the Board conflict).

Where a Board is dominated by representatives of the preferred stock and the merger consideration is only adequate to cover part of the amount the charter provides the holders of preferred are entitled to and leaves nothing for the common stock, the Board may be sued for breach of fiduciary duty and the buyer may also be sued for aiding and abetting the Board's alleged violation of its fiduciary duties. In *Morgan v. Cash*,⁴⁷¹ a former common shareholder of Voyence, Inc. sued EMC Corporation (the acquirer of Voyence) for aiding and abetting alleged breaches of fiduciary duties by the former Voyence Board and also sued the Board for breaching its fiduciary duties. The plaintiff alleged that EMC used promises of continued employment and exploited conflicts of interest between the Voyence directors (all of whom held preferred stock or were designees of holders of preferred stock) and common stockholders to gain Voyence management's support for a low cash merger price, which resulted in the preferred stock taking a discount from the price to which it was entitled under its terms and the holders of common stock receiving nothing. Because none of the consideration from the sale was distributed to Voyence's common shareholders, plaintiff argued that EMC was complicit in the Board's failure to maximize stockholder value in the sale of the Voyence. The Chancery Court granted EMC's motion to be dismissed from the shareholder litigation, commenting that "[i]t is not a status crime under Delaware law to buy an entity for a price that does not result in a payment to the selling entity's common stockholders." The Court determined that allegations of modest employment packages offered to two directors, standing alone, did not suggest that the Voyence Board accepted a low merger price in exchange for improper personal benefits, and the fact that Voyence directors received consideration from the sale of the corporation, and common shareholders did not, was not enough to sustain a claim of collusion between EMC and the Voyence directors.

In *Johnston v. Pedersen*,⁴⁷² the Court of Chancery held that directors violated their duty of loyalty when designing and issuing a new series of preferred stock because they intentionally "structure[d] the stock issuance to prevent an insurgent group from waging a successful proxy contest." As a result, the holders of the new series of preferred stock were held not entitled to a class vote in connection with the removal of the incumbent Board and the election of a new slate by written consent.

(d) Voting Rights of Preferred Stock. The voting rights of holders of preferred stock are set forth in a corporation's certificate of incorporation and in the DCL or TBOC, as the case may be.⁴⁷³ A certificate of incorporation may either authorize special voting preferences or it may deny all voting rights to the holders of preferred stock.⁴⁷⁴ If there is no special provision in

⁴⁷¹ C.A. No. 5053-VCS, 2010 WL 2803746, at *1 (Del. Ch. July 16, 2010).

⁴⁷² 28 A.3d 1079, 1081 (Del. Ch. 2011).

⁴⁷³ The rights and preferences of preferred stock and other classes of stock are set forth in a certificate of designations. When a certificate of designations is filed with the Secretary of State, it has the effect of amending the certificate of incorporation and, as a result, the rights of the preferred stockholders become part of the certificate of incorporation. TBOC § 21.156; DGCL § 151(g).

⁴⁷⁴ TBOC §§ 21.152, 21.153, 21.154 and 21.155; DGCL § 151(a) provides that "Every corporation may issue 1 or more classes of stock, or 1 or more series of stock within any class thereof, any or all of which classes may be of stock with par value or stock without par value and which classes or series may have such voting

the certificate of incorporation regarding the voting rights of preferred stockholders, all stockholders are entitled to one vote per share as a single class with no preferential voting rights for any holders of preferred stock.⁴⁷⁵ Both Delaware and Texas law require a separate class vote if there is an amendment to the certificate of incorporation which (i) increases or decreases the aggregate number of authorized shares of the class or series; (ii) changes the designations, preferences or rights (including voting rights) of the class or series; or (iii) creates new classes or series of shares.⁴⁷⁶ This class vote requirement is not applicable to the creation and issuance of a new series of preferred shares pursuant to Board authorization under blank check preferred stock provisions in a certificate of incorporation, unless the certificate of incorporation specifically otherwise requires.⁴⁷⁷

Under Delaware law, holders of preferred stock are not entitled to vote as a class on a merger, even though the merger effects an amendment to the certificate of incorporation that would have to be approved by a class vote if the amendment were effected directly by an amendment to the certificate of incorporation, unless the certificate of incorporation expressly requires a class vote to approve a merger.⁴⁷⁸ DGCL § 242(b)(2) provides generally with respect

powers, full or limited, or no voting powers, and such designations, preferences and relative, participating, optional or other special rights, and qualifications, limitations or restrictions thereof, as shall be stated and expressed in the certificate of incorporation...”

⁴⁷⁵ TBOC §§ 21.363, 21.364, 21.365 and 21.366; DGCL § 212(a).

⁴⁷⁶ TBOC § 21.364(d); DGCL § 242(b)(2). Under TBOC § 21.155, the Board may establish new series of shares of any class if expressly authorized by the certificate of formation, and if the certificate of formation does not “expressly restrict the board of directors from increasing or decreasing the number of unissued shares of a series...the board of directors may increase or decrease the number of shares” with the exception of decreasing the number of shares below the number of shares that are currently issued at the time of the decrease.

⁴⁷⁷ TBOC § 21.364; DGCL §§ 151 and 242.

⁴⁷⁸ In *VantagePoint Venture Partners 1996 v. Examen, Inc.*, 871 A.2d 1108, 1112 (Del. 2005) the Delaware Supreme Court considered whether a class of preferred stock would be entitled to vote as a separate class on the approval of a merger agreement and ruled that Delaware law, rather than California law, governed and did not require the approval of the holders of the preferred stock voting separately as a class for approval of the merger. In reaching that conclusion, the Court held that the DGCL exclusively governs the internal corporate affairs of a Delaware corporation and that Section 2115 of the California Corporations Code, which requires a corporation with significant California contacts (sometimes referred to as a “quasi-California corporation”) to comply with certain provisions of the California Corporations Code even if the corporation is incorporated in another state, such as Delaware, is unconstitutional and, as a result of Delaware rather than California law governing, the approval of the merger did not require the approval of the holders of the preferred stock voting separately as a class).

Section 2115 of the California Corporations Code provides that, irrespective of the state of incorporation, the articles of incorporation of a foreign corporation are deemed amended to conform to California law if (i) more than 50% of its business (as defined) was derived from California during its last fiscal year and (ii) more than 50% of its outstanding voting securities are held by persons with California addresses. Section 1201 of the California Corporations Code requires that the principal terms of a merger be approved by the outstanding shares of each class.

Under Examen’s certificate of incorporation and Delaware law, a proposed merger of Examen with an unrelated corporation required only the affirmative vote of the holders of a majority of the outstanding shares of common stock and preferred stock, voting together as a single class. The holders of Examen’s preferred stock did not have enough votes to block the merger if their shares were voted as a single class with the common stock. Thus they sued in Delaware to block the merger based on the class vote requirements of the California statute.

to amendments to certificates of incorporation that the “holders of the outstanding shares of a class shall be entitled to vote as a class upon a proposed amendment, whether or not entitled to vote thereon by the certificate of incorporation, if the amendment would . . . alter or change the powers, preferences, or special rights of the shares of such class so as to affect them adversely.” In *Warner Communications Inc. v. Chris-Craft Indus., Inc.*,⁴⁷⁹ the provision of the Warner certificate of incorporation at issue required a two-thirds class vote of the preferred stock to amend, alter or repeal any provision of the certificate of incorporation if such action adversely affected the preferences, rights, powers or privileges of the preferred stock. Warner merged with a Time subsidiary and was the surviving corporation. In the merger, the Warner preferred stock was converted into Time preferred stock and the Warner certificate of incorporation was amended to delete the terms of the preferred stock. The Chancery Court rejected the argument that holders of the preferred stock were entitled to a class vote on the merger, reasoning that any adverse effect on the preferred stock was caused not by an amendment of the terms of the stock, but solely by the conversion of the stock into a new security in the merger pursuant to DGCL § 251. The Chancery Court also reasoned that the language of the class vote provision at issue was similar to DGCL § 242 and did not expressly apply to mergers.⁴⁸⁰ In contrast, in *Elliott Assocs., L.P. v. Avatex Corp.*⁴⁸¹ the certificate of incorporation provision expressly gave preferred stockholders a class vote on the “amendment, alteration or repeal, whether by merger, consolidation or otherwise” of provisions of the certificate of incorporation so as to adversely affect the rights of the preferred stock, and preferred stock was converted into common stock of the surviving corporation of a merger. The Court in *Elliott*, for purposes of its opinion, assumed that the preferred stock was adversely affected, distinguished *Warner* because the charter contained the “whether by merger, consolidation or otherwise” language, and held that the preferred stock had a right to a class vote on the merger because the adverse effect was caused by the repeal of the charter and the stock conversion. The Court in *Elliott* commented that the “path for future drafters to follow in articulating class vote provisions is clear”: “When a certificate (like the Warner certificate or the Series A provisions here) grants only the right to vote on an amendment, alteration or repeal, the preferred have no class vote in a merger. When a certificate (like the First Series Preferred certificate here) adds the terms ‘whether by merger, consolidation

⁴⁷⁹ 583 A.2d 962, 964 (Del. Ch. 1989), *aff’d*, 567 A.2d 419 (Del. 1989).

⁴⁸⁰ *See Sullivan Money Mgmt., Inc. v. FLS Holdings, Inc.*, C.A. No. 12731, 1992 WL 345453, at *1195 (Del. Ch. Nov. 20, 1992), *aff’d*, 628 A.2d 84 (Del. 1993) (where the certificate of incorporation required a class vote of the preferred stockholders for the corporation to “change, by amendment to the Certificate of incorporation . . . or otherwise,” the terms and provisions of the preferred stock, the Court held that “or otherwise” cannot be interpreted to mean merger in the context of a reverse triangular merger in which the preferred stock was converted into cash but the corporation survived); *see also Matulich v. Aegis Communications Group, Inc.*, 942 A.2d 596, 601 (Del. 2008) (where certificate of designation of preferred stock provided that holders of the preferred stock had no voting rights but had the right of approval and consent prior to any merger, the holders of the preferred stock did not have any statutory right to vote on a merger, but had only a distinguishable contractual right to approve of and consent to mergers; thus since plaintiff’s preferred stock was not entitled to vote on the merger, the holder of over 90% of the stock entitled to vote on the merger could approve a short form merger under DGCL § 253 and does not have to establish the entire fairness of the merger).

⁴⁸¹ 715 A.2d 843, 855 (Del. 1998).

or otherwise' and a merger results in an amendment, alteration or repeal that causes an adverse effect on the preferred, there would be a class vote."⁴⁸²

Under Texas law and unless the charter otherwise provides, approval of a merger or other fundamental business transaction requires the affirmative vote of the holders of two-thirds of (i) all of the corporation's outstanding shares entitled to vote voting as a single class and (ii) each class entitled to vote as a class or series thereon.⁴⁸³ Separate voting by a class or series of shares of a corporation is required by TBOC § 21.458 (and was required by TBCA art. 5.03.E) for approval of a plan of merger only if (a) the charter so provides or (b) the plan of merger contains a provision that if contained in an amendment to the charter would require approval by that class or series under TBOC § 21.364 (or previously under TBCA art. 4.03), which generally require class voting on amendments to the certificate of formation, which change the designations, preferences, limitations or relative rights or a class or series or otherwise affect the class or series in specified respects.⁴⁸⁴ A merger in which all of a corporation's stock is converted into cash

⁴⁸² *Id.* at 855. See *Benchmark Capital Partners IV, L.P. v. Vague*, No. 19719, 2002 Del. Ch. LEXIS 90, at *25 (Del. Ch. July 15, 2002) (“[A court’s function in ascertaining the rights of preferred stockholders] is essentially one of contract interpretation.”), *aff’d sub nom. Benchmark Capital Partners IV, L.P. v. Juniper Fin. Corp.*, 822 A.2d 396 (Del. 2003); and *Watchmark Corp. v. ARGO Global Capital, LLC, et al*, C.A. 711-N, 2004 WL 2694894, at *4 (Del. Ch. Nov. 4, 2004) (“Duties owed to preferred stockholders are ‘primarily . . . contractual in nature,’ involving the ‘rights and obligations created contractually by the certificate of designation.’ If fiduciary duties are owed to preferred stockholders, it is only in limited circumstances. Whether a given claim asserted by preferred stockholders is governed by contractual or fiduciary duty principles, then, depends on whether the dispute arises from rights and obligations created by contract or from ‘a right or obligation that is not by virtue of a preference but is shared equally with the common.’”).

⁴⁸³ TBOC § 21.457; TBCA art. 5.03(F).

⁴⁸⁴ TBOC § 21.364 provides:

Sec. 21.364. VOTE REQUIRED TO APPROVE FUNDAMENTAL ACTION. (a) In this section, a "fundamental action" means:

- (1) an amendment of a certificate of formation, including an amendment required for cancellation of an event requiring winding up in accordance with Section 11.152(b);
- (2) a voluntary winding up under Chapter 11;
- (3) a revocation of a voluntary decision to wind up under Section 11.151;
- (4) a cancellation of an event requiring winding up under Section 11.152(a); or
- (5) a reinstatement under Section 11.202.

(b) Except as otherwise provided by this code or the certificate of formation of a corporation in accordance with Section 21.365, the vote required for approval of a fundamental action by the shareholders is the affirmative vote of the holders of at least two-thirds of the outstanding shares entitled to vote on the fundamental action.

(c) If a class or series of shares is entitled to vote as a class or series on a fundamental action, the vote required for approval of the action by the shareholders is the affirmative vote of the holders of at least two-thirds of the outstanding shares in each class or series of shares entitled to vote on the action as a class or series and at least two-thirds of the outstanding shares otherwise entitled to vote on the action. Shares entitled to vote as a class or series shall be entitled to vote only as a class or series unless otherwise entitled to vote on each matter submitted to the shareholders generally or otherwise provided by the certificate of formation.

(d) Unless an amendment to the certificate of formation is undertaken by the board of directors under Section 21.155, separate voting by a class or series of shares of a corporation is required for approval of an amendment to the certificate of formation that would result in:

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- (1) the increase or decrease of the aggregate number of authorized shares of the class or series;
 - (2) the increase or decrease of the par value of the shares of the class or series, including changing shares with par value into shares without par value or changing shares without par value into shares with par value;
 - (3) effecting an exchange, reclassification, or cancellation of all or part of the shares of the class or series;
 - (4) effecting an exchange or creating a right of exchange of all or part of the shares of another class or series into the shares of the class or series;
 - (5) the change of the designations, preferences, limitations, or relative rights of the shares of the class or series;
 - (6) the change of the shares of the class or series, with or without par value, into the same or a different number of shares, with or without par value, of the same class or series or another class or series;
 - (7) the creation of a new class or series of shares with rights and preferences equal, prior, or superior to the shares of the class or series;
 - (8) increasing the rights and preferences of a class or series with rights and preferences equal, prior, or superior to the shares of the class or series;
 - (9) increasing the rights and preferences of a class or series with rights or preferences later or inferior to the shares of the class or series in such a manner that the rights or preferences will be equal, prior, or superior to the shares of the class or series;
 - (10) dividing the shares of the class into series and setting and determining the designation of the series and the variations in the relative rights and preferences between the shares of the series;
 - (11) the limitation or denial of existing preemptive rights or cumulative voting rights of the shares of the class or series;
 - (12) canceling or otherwise affecting the dividends on the shares of the class or series that have accrued but have not been declared; or
 - (13) the inclusion or deletion from the certificate of formation of provisions required or permitted to be included in the certificate of formation of a close corporation under Subchapter O.
- (e) The vote required under Subsection (d) by a class or series of shares of a corporation is required notwithstanding that shares of that class or series do not otherwise have a right to vote under the certificate of formation.
- (f) Unless otherwise provided by the certificate of formation, if the holders of the outstanding shares of a class that is divided into series are entitled to vote as a class on a proposed amendment that would affect equally all series of the class, other than a series in which no shares are outstanding or a series that is not affected by the amendment, the holders of the separate series are not entitled to separate class votes.
- (g) Unless otherwise provided by the certificate of formation, a proposed amendment to the certificate of formation that would solely effect changes in the designations, preferences, limitations, or relative rights, including voting rights, of one or more series of shares of the corporation that have been established under the authority granted to the board of directors in the certificate of formation in accordance with Section 21.155 does not require the approval of the holders of the outstanding shares of a class or series other than the affected series if, after giving effect to the amendment:
- (1) the preferences, limitations, or relative rights of the affected series may be set and determined by the board of directors with respect to the establishment of a new series of shares under the authority granted to the board of directors in the certificate of formation in accordance with Section 21.155; or

would affect all shareholders and, thus, would require approval of (i) all of the outstanding shares entitled to vote on the merger and (ii) a separate vote of each class or series.⁴⁸⁵ Unless a corporation's charter provides otherwise, the foregoing Texas merger approval requirements (but not the charter amendment requirements) are subject to exceptions for (a) mergers in which the corporation will be the sole survivor and the ownership and voting rights of the shareholders are not substantially impaired,⁴⁸⁶ (b) mergers affected to create a holding company,⁴⁸⁷ and (c) short form mergers.⁴⁸⁸

2.6.7. Derivative Actions.

(a) Delaware and Texas Authorize Derivative Actions. The fiduciary duties of directors and officers are generally owed to the corporation they serve and not to any individual shareholders.⁴⁸⁹ Thus, a cause of action against a director or officer for breach of fiduciary duty would be vested in, and brought by or in the right of, the corporation.⁴⁹⁰ Since the cause of action belongs to the corporation and the power to manage the business and affairs of a corporation generally resides in its Board,⁴⁹¹ a disinterested Board would have the power to determine whether to bring or dismiss a breach of fiduciary duty claim for the corporation.⁴⁹²

(2) any new series established as a result of a reclassification of the affected series are within the preferences, limitations, and relative rights that are described by Subdivision (1).

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Id.

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TBOC § 21.459(a); TBCA art. 5.03(G).

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TBOC §§ 10.005, 21.459(b); TBCA art. 5.03(H)–5.03(K).

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TBOC §§ 10.006, 21.459(b); TBCA art. 5.16(A)–5.16(F).

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Somers v. Crane, 295 S.W.3d 5, 11-12 (Tex. App.—Houston [1st Dist.] 2009, pet. denied); *R2 Enterprises v. Whipple*, 2008 WL 2553444 (Tex. App.—Fort Worth 2008) (“An individual stakeholder in a legal entity does not have a right to recover personally for harms done to the legal entity. *Wingate v. Hajdik*, 795 S.W.2d 717, 719 (Tex. 1990); *Nauslar v. Coors Brewing Co.*, 170 S.W. 3rd 242, 250 (Tex. App.—Dallas 2005, no pet.) (applying rule to partnerships). A stakeholder does not have standing to seek damages on a cause of action belonging to an entity alone, such as when the damages are based on diminution of the entity's worth or the entity's loss of profits.”). See *supra* note 439 and related text, and *infra* notes 577-579 and related text.

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Redmon v. Griffith, 202 S.W.3d 225, 233-234 (Tex. App.—Tyler 2006, pet. denied); *Somers v. Crane*, 295 S.W.3d 5, 11-12 (Tex. App.—Houston [1st Dist.] 2009, pet. denied) (“[B]ecause of the abundant authority stating that a director's or officer's fiduciary duty runs only to the corporation, not to individual shareholders, we decline to recognize the existence of a fiduciary relationship owed directly by a director to a shareholder in the context of a cash-out merger. Accordingly, we hold that the Class cannot bring a cause of action directly against appellees for breach of fiduciary duty.”); *A. Copeland Enters., Inc. v. Guste*, 706 F. Supp. 1283, 1288 (W.D. Tex. 1989) (“Claims concerning breach of a corporate director's fiduciary duties can only be brought by a shareholder in a derivative suit because a director's duties run to the corporation, not to the shareholder in his own right.”).

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DGCL § 141(a); *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984).

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See *Wingate v. Hajdik*, 795 S.W.2d 717, 719 (Tex. 1990) (“Ordinarily, the cause of action for injury to the property of a corporation, or the impairment or destruction of its business, is vested in the corporation, as distinguished from its stockholders”); *Pace v. Jordan*, 999 S.W.2d 615, 622 (Tex. App.—Houston [1st Dist.] 1999, pet. denied) (noting that “[a] corporation's directors, not its shareholders, have the right to control litigation of corporate causes of action”).

Both Delaware⁴⁹³ and Texas⁴⁹⁴ law authorize an action brought in the right of the corporation by a shareholder against directors or officers for breach of fiduciary duty.⁴⁹⁵ Such an action is called a “derivative action.”

Both Delaware and Texas also recognize situations where a derivative claim may be brought directly (rather than in a derivative action) by an injured shareholder.⁴⁹⁶ In *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, the Delaware Supreme Court set forth the analytical framework for ascertaining whether a cause of action is direct or derivative in Delaware and held that this determination can be made by answering two questions: “[W]ho suffered the alleged harm . . . and who would receive the benefit of any recovery or other remedy . . . ?”⁴⁹⁷ The Delaware Supreme Court elaborated on this analysis in *Feldman v. Cutaia*:

If the corporation alone, rather than the individual stockholder, suffered the alleged harm, the corporation alone is entitled to recover, and the claim in question is derivative. Conversely, if the stockholder suffered harm independent of any injury to the corporation that would entitle him to an individualized recovery, the cause of action is direct.⁴⁹⁸

In *Gentile v. Rossette*,⁴⁹⁹ the Delaware Supreme Court established that certain equity dilution claims may be pled both derivatively and directly against a controlling shareholder and directors who authorized an unfair self-dealing transaction with the controlling shareholder. In *Gentile*, the plaintiffs were former minority shareholders suing for breach of fiduciary duty against the corporation’s former directors and its CEO/controlling stockholder arising from a self-dealing transaction in which the CEO/controlling stockholder forgave the corporation’s debt to him in exchange for being issued stock whose value allegedly exceeded the value of the forgiven debt. The transaction wrongfully reduced the cash-value and the voting power of the public stockholders’ minority interest, and increased correspondingly the value and voting power of the controller’s majority interest. After the debt conversion, the corporation was later acquired by another company in a merger and shortly after the merger, the acquirer filed for

⁴⁹³ DEL. CT. OF CHANCERY R. 23.1.

⁴⁹⁴ TBCA art. 5.14; TBOC §§ 21.551-21.563.

⁴⁹⁵ TBCA art. 5.14; TBOC §§ 21.551-21.563.

⁴⁹⁶ See *infra* note 510 and related text (TBOC § 21.563 permitting a claim by a shareholder of a closely held corporation to be treated as a direct claim if justice requires); *Moroney v. Moroney*, 286 S.W. 167, 170 (Tex. Com. App. 1926) (applying Texas law and allowing the shareholder to pursue a direct claim for payment of dividends, reasoning that the claim “is not so much an action by the wards to recover damages to their stock, as it is to recover a loss of specific profits they would have earned”); see *infra* notes 497-499 and related text (highlighting Delaware case law allowing a derivative claim to be brought directly).

⁴⁹⁷ 845 A.2d 1031, 1033 (Del. 2004).

⁴⁹⁸ 951 A.2d 727, 732 (Del. 2008). Compare *In re Primedia, Inc. Shareholders Litigation (Primedia II)*, 67 A.3d 455, 478 (Del. Ch. May 10, 2013) (plaintiffs whose standing to pursue derivative insider trading claims had been extinguished by merger had standing in a class action to challenge directly the entire fairness of that merger based on a claim that the target Board failed to obtain sufficient value in the merger for the pending derivative claims) to *Binks v. DSL.net, Inc.*, C.A. No. 2823-VCN, 2010 Del. Ch. LEXIS 98, at *47 (Del. Ch. April 29, 2010) (claims that Board breached its fiduciary duties by authorizing the sale of convertible notes so cheaply that waste of corporate assets resulted are derivative).

⁴⁹⁹ 906 A.2d 91, 103 (Del. 2006). See *supra* notes 404-411 and related text.

bankruptcy and was liquidated. The plaintiffs then sued in the Court of Chancery to recover the value of which they claimed to have been wrongfully deprived in the debt conversion. The Supreme Court held that the former minority stockholders could bring a direct claim against the fiduciaries responsible for the debt conversion transaction complained of. In so holding Justice Jacobs explained:

To analyze the character of the claim at issue, it is critical to recognize that it has two aspects. The first aspect is that the corporation . . . was caused to overpay for an asset or other benefit that it received in exchange (here, a forgiveness of debt). The second aspect is that the minority stockholders lost a significant portion of the cash value and the voting power of their minority stock interest. Those separate harms resulted from the same transaction, yet they are independent of each other.

Normally, claims of corporate overpayment are treated as causing harm solely to the corporation and, thus, are regarded as derivative. The reason (expressed in *Tooley* terms) is that the corporation is both the party that suffers the injury (a reduction in its assets or their value) as well as the party to whom the remedy (a restoration of the improperly reduced value) would flow. In the typical corporate overpayment case, a claim against the corporation's fiduciaries for redress is regarded as exclusively derivative, irrespective of whether the currency or form of overpayment is cash or the corporation's stock. Such claims are not normally regarded as direct, because any dilution in value of the corporation's stock is merely the unavoidable result (from an accounting standpoint) of the reduction in the value of the entire corporate entity, of which each share of equity represents an equal fraction. In the eyes of the law, such equal "injury" to the shares resulting from a corporate overpayment is not viewed as, or equated with, harm to specific shareholders individually.

There is, however, at least one transactional paradigm—a species of corporate overpayment claim—that Delaware case law recognizes as being both derivative and direct in character. A breach of fiduciary duty claim having this dual character arises where: (1) a stockholder having majority or effective control causes the corporation to issue "excessive" shares of its stock in exchange for assets of the controlling stockholder that have a lesser value; and (2) the exchange causes an increase in the percentage of the outstanding shares owned by the controlling stockholder, and a corresponding decrease in the share percentage owned by the public (minority) shareholders. Because the means used to achieve that result is an overpayment (or "over-issuance") of shares to the controlling stockholder, the corporation is harmed and has a claim to compel the restoration of the value of the overpayment. That claim, by definition, is derivative.

But, the public (or minority) stockholders also have a separate, and direct, claim arising out of that same transaction. Because the shares representing the "overpayment" embody both economic value and voting power, the end result of this type of transaction is an improper transfer—or expropriation—of economic value and voting power from the public shareholders to the majority or controlling

stockholder. For that reason, the harm resulting from the overpayment is not confined to an equal dilution of the economic value and voting power of each of the corporation's outstanding shares. A separate harm also results: an extraction from the public shareholders, and a redistribution to the controlling shareholder, of a portion of the economic value and voting power embodied in the minority interest. As a consequence, the public shareholders are harmed, uniquely and individually, to the same extent that the controlling shareholder is (correspondingly) benefited. In such circumstances, the public shareholders are entitled to recover the value represented by that overpayment—an entitlement that may be claimed by the public shareholders directly and without regard to any claim the corporation may have.

In deference to the power of the Board, a shareholder would ordinarily be expected to demand that the Board commence the action before commencing a derivative action on behalf of the corporation.⁵⁰⁰ An independent and disinterested Board could then decide whether commencing the action would be in the best interest of the corporation and, if it concludes that the action would not be in the best interest of the corporation, could decide to have the action dismissed.⁵⁰¹ Delaware and Texas differ in cases in which making such a demand upon the

⁵⁰⁰ DEL. CT. OF CHANCERY R. 23.1; TBCA art. 5.14(C); TBOC § 21.553.

⁵⁰¹ TBCA art. 5.14(F); TBOC § 21.558, which provides:

Section 21.558. Dismissal of Derivative Proceeding. (a) A court shall dismiss a derivative proceeding on a motion by the corporation if the person or group of persons described by Section 21.554 determines in good faith, after conducting a reasonable inquiry and based on factors the person or group considers appropriate under the circumstances, that continuation of the derivative proceeding is not in the best interests of the corporation.

(b) In determining whether the requirements of Subsection (a) have been met, the burden of proof shall be on:

(1) the plaintiff shareholder if:

(A) the majority of the board of directors consists of independent and disinterested directors at the time the determination is made;

(B) the determination is made by a panel of one or more independent and disinterested persons appointed under Section 21.554(a)(3); or

(C) the corporation presents prima facie evidence that demonstrates that the directors appointed under Section 21.554(a)(2) are independent and disinterested; or

(2) the corporation in any other circumstance.

TBOC § 21.554 provides an alternative for dismissal of derivative action upon determination by an independent and disinterested person appointed by the court, which can be helpful in the event that the requisite independent and disinterested directors are not available, as follows:

Section 21.554. Determination by Directors or Independent Persons. (a) A determination of how to proceed on allegations made in a demand or petition relating to a derivative proceeding must be made by an affirmative vote of the majority of:

(1) the independent and disinterested directors of the corporation present at a meeting of the board of directors of the corporation at which interested directors are not present at the time of the vote if the independent and disinterested directors constitute a quorum of the board of directors;

(2) a committee consisting of two or more independent and disinterested directors appointed by an affirmative vote of the majority of one or more independent and disinterested directors present at a meeting of the board of directors, regardless of

Board is likely to have little or no effect, generally because a majority of the Board lacks independence or is otherwise interested in the actions being disputed.

(b) Texas Derivative Actions.

(1) Standing; Demand. In Texas, a shareholder⁵⁰² may not institute or maintain a derivative proceeding unless he (i) was a shareholder at the time of the act or omission complained of (or became a shareholder by operation of law from such a shareholder) and (ii)

whether the independent and disinterested directors constitute a quorum of the board of directors; or

(3) a panel of one or more independent and disinterested persons appointed by the court on a motion by the corporation listing the names of the persons to be appointed and stating that, to the best of the corporation's knowledge, the persons to be appointed are disinterested and qualified to make the determinations contemplated by Section 21.558.

(b) The court shall appoint a panel under Subsection (a)(3) if the court finds that the persons recommended by the corporation are independent and disinterested and are otherwise qualified with respect to expertise, experience, independent judgment, and other factors considered appropriate by the court under the circumstances to make the determinations. A person appointed by the court to a panel under this section may not be held liable to the corporation or the corporation's shareholders for an action taken or omission made by the person in that capacity, except for an act or omission constituting fraud or willful misconduct.

The proceedings and discovery are stayed under the Tex. Corp. Stats. while the decision is being made whether to pursue or dismiss the action. TBOC § 21.555 provides:

Section 21.555. Stay of Proceeding. (a) If the domestic or foreign corporation that is the subject of a derivative proceeding commences an inquiry into the allegations made in a demand or petition and the person or group of persons described by Section 21.554 is conducting an active review of the allegations in good faith, the court shall stay a derivative proceeding until the review is completed and a determination is made by the person or group regarding what further action, if any, should be taken.

(b) To obtain a stay, the domestic or foreign corporation shall provide the court with a written statement agreeing to advise the court and the shareholder making the demand of the determination promptly on the completion of the review of the matter. A stay, on application, may be reviewed every 60 days for the continued necessity of the stay.

(c) If the review and determination made by the person or group is not completed before the 61st day after the stay is ordered by the court, the stay may be renewed for one or more additional 60-day periods if the domestic or foreign corporation provides the court and the shareholder with a written statement of the status of the review and the reasons why a continued extension of the stay is necessary.

In the event that a decision is made to seek dismissal of the proceeding, discovery is limited by the Tex. Corp. Stats. to whether (i) the person making the decision to dismiss was independent and disinterested; (ii) the good faith of the inquiry and review, and (iii) the reasonableness of the procedures. TBCA art.5.14; TBOC § 21.556.

See infra notes 547-552 (discussing the meaning of “independent” and “disinterested” in the context of director action to dismiss a shareholder derivative action). *See Johnson v. Jackson Walker, L.L.P.*, 247 S.W.3d 765, 769 (Tex. App.—Dallas 2008, pet. denied).

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“Shareholder” is defined in TBOC §§ 1.002 and 21.551(2) to include the record owner and a beneficial owner whose shares are held by a voting trust or nominee to the extent of rights granted by a nominee statement on file with the corporation. Thus, a shareholder of a parent company may bring a derivative action for fiduciary duty breaches by an officer of a subsidiary as a shareholder of the parent is a beneficial owner of shares of the subsidiary. *See Webre v. Sneed*, 358 S.W.3d 322, 330 (Tex. App.—Houston [1st Dist.] 2011, pet. granted), later proceeding at 2014 Tex. LEXIS 779 (Aug. 29, 2014).

fairly and adequately represents the interests of the corporation in enforcing the right of the corporation.⁵⁰³ Further, the plaintiff must remain a qualified shareholder throughout the derivative proceedings.⁵⁰⁴

A shareholder bringing a derivative suit on behalf of a Texas corporation *must* file a written demand in order to maintain the suit, and no showing of futility can excuse this requirement.⁵⁰⁵ Moreover, a 90-day waiting period is required from the delivery of the demand notice until the commencement of a suit.⁵⁰⁶ This waiting period can only be avoided if the

⁵⁰³ TBOC § 21.552 provides:

Sec. 21.552. STANDING TO BRING PROCEEDING. (a) A shareholder may not institute or maintain a derivative proceeding unless:

(1) the shareholder:

(A) was a shareholder of the corporation at the time of the act or omission complained of; or

(B) became a shareholder by operation of law from a person that was a shareholder at the time of the act or omission complained of; and

(2) the shareholder fairly and adequately represents the interests of the corporation in enforcing the right of the corporation.

TBOC § 21.563(b) provides that TBOC § 21.552 does not apply to a closely held corporation (defined as one with fewer than 35 shareholders and no public trading market for its shares. *See infra* note 509 and related text.

⁵⁰⁴ *Somers v. Crane*, 295 S.W.3d 5, 14 (Tex. App.—Houston [1st Dist.] 2009, pet. denied); *Zauber v. Murray Sav. Ass'n*, 591 S.W.2d 932, 935 (Tex. Civ. App. – Dallas 1979), writ ref'd per curiam, 601 S.W.2d 940 (Tex. 1980). *See infra* notes 541-545 and related text.

⁵⁰⁵ TBOC § 21.553(a); TBCA art. 514(C)(1). The Tex. Corp. Stats. apply to corporations formed under the laws of a jurisdiction other than Texas (a “*foreign corporation*”) transacting business in Texas. TBOC §§ 21.001(2), (7); TBCA art. 1.02(A)(14). In a derivative proceeding brought in Texas in the right of a foreign corporation, the requirement that the shareholder make written demand is governed by the laws of the jurisdiction where the foreign corporation is incorporated. TBOC § 21.562(a); TBCA art. 5.14(K). Even though the substantive law of the jurisdiction where the foreign corporation is incorporated applies, Texas procedural law governs matters of remedy and procedure. *Connolly v. Gasmire*, 257 S.W.3d 831, 839 (Tex. App.—Dallas 2008, no pet.).

Under Texas procedural law, a party is generally required to file a special exception to challenge a defective pleading. *See* TEX. R. CIV. P. 90, 91 (providing the means for a party to specifically except to an adverse party’s pleadings, and providing that a special exception shall point out the pleading excepted to and, with particularity, the defect or insufficiency in the allegations of the pleading). The purpose of special exceptions is to furnish a party with a medium by which to force clarification of an adverse party’s pleadings when they are not clear or sufficiently specific. *Id.*

When a trial court sustains a party’s special exceptions, the trial court must give the pleader an opportunity to amend his pleadings before dismissing the case. When a petition fails to satisfy the requirements for demand futility under the laws of a foreign jurisdiction, the proper remedy under Texas procedural law is to sustain the special exceptions and allow the plaintiff an opportunity to amend the petition, even if dismissal is the proper remedy under the laws of the foreign jurisdiction. *Id.*

⁵⁰⁶ TBCA art. 5.14(C)(2); TBOC § 21.553. TBOC § 21.553 provides:

Section 21.553. Demand. (a) A shareholder may not institute a derivative proceeding until the 91st day after the date a written demand is filed with the corporation stating with particularity the act, omission, or other matter that is the subject of the claim or challenge and requesting that the corporation take suitable action.

(b) The waiting period required by Subsection (a) before a derivative proceeding may be instituted is not required if:

shareholder is earlier notified that the Board has rejected his demand, or if “irreparable harm to the corporation is being suffered or would result by waiting for the expiration of the 90-day period.”⁵⁰⁷

The written demand must meet a stringent set of particularity requirements in order to satisfy the Tex. Corp. Stats.⁵⁰⁸ Though much of the analysis done by the courts to evaluate

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- (1) the shareholder has been previously notified that the demand has been rejected by the corporation;
 - (2) the corporation is suffering irreparable injury; or
 - (3) irreparable injury to the corporation would result by waiting for the expiration of the 90-day period.

⁵⁰⁷ TBCA art. 5.14(C)(2); TBOC § 21.553(b).

⁵⁰⁸ In *In re Schmitz*, 285 S.W.3d 451, 455 (Tex. 2009), the Texas Supreme Court rejected a shareholder challenge to a merger and held that merely alleging (a) the availability of a superior offer price and (b) the Board’s duty to “‘fully and fairly consider all potential offers’ and ‘disclose to shareholders all of [their] analysis,’” without further analysis of the proposed transactions and explanation of the Board’s failure to fulfill their duties, is not sufficient to meet article 5.14’s particularity requirement. In so holding, the Texas Supreme Court wrote:

The contours of the demand requirement in Texas law have always been somewhat unclear, in part because shareholder derivative suits have been relatively rare.

* * *

In 1997, the Legislature extensively revised the Texas Business Corporation Act “to provide Texas with modern and flexible business laws which should make Texas a more attractive jurisdiction in which to incorporate.” Included were changes to article 5.14 to conform Texas derivative actions to the Model Business Corporation Act. Article 5.14(C) now provides that “[n]o shareholder may commence a derivative proceeding until . . . a written demand is filed with the corporation setting forth with particularity the act, omission, or other matter that is the subject of the claim or challenge and requesting that the corporation take suitable action.” Unlike Texas law for a century before, the new provision requires presuit demand in all cases; a shareholder can no longer avoid a demand by proving it would have been futile.

* * *

Article 5.14 does not expressly state that a presuit demand must list the name of a shareholder. But because parts of the article and most of its purposes would be defeated otherwise, we hold that a demand cannot be made anonymously.

The statute here provides that “[n]o shareholder may commence a derivative proceeding until . . . a written demand is filed.” It expressly limits standing to shareholders who owned stock “at the time of the act or omission complained of.” It requires that the demand state “the subject of the claim or challenge” that forms the basis of the suit. And it tolls limitations for 90 days after a written demand is filed. Given the interrelation between the demand and the subsequent suit, it is hard to see how or why the demand could be made by anyone other than the shareholder who will file the suit.

Of course, requiring the demand to come from the putative plaintiff is not the same as requiring that it state the plaintiff’s name. But for several reasons we believe it must.

First, article 5.14 presumes that a corporation knows the identity of the shareholder making the demand. The article prohibits filing suit until 90 days after the demand “unless the shareholder has earlier been notified that the demand has been rejected.” The tolling provision suspends limitations for the shorter of 90 days or “30 days after the corporation advises the shareholder that the demand has been rejected.” For a corporation to “notify” or “advise” the shareholder of rejection, it must know who the shareholder is.

potential “irreparable harm” may be similar to the analysis required for demand futility claims in Delaware, the fact that the Tex. Corp. Stats. focus on the harm to the corporation, rather than the apparent futility of demand, presents a slightly different set of issues than are normally addressed in cases involving Delaware corporations.

Second, the identity of the shareholder may play an important role in how the corporation responds to a demand. “The identity of the complaining shareholder may shed light on the veracity or significance of the facts alleged in the demand letter, and the Board might properly take a different course of action depending on the shareholder’s identity.” In other words, a demand from Warren Buffett may have different implications than one from Jimmy Buffett.

Third, a corporation cannot be expected to incur the time and expense involved in fully investigating a demand without verifying that it comes from a valid source. Article 5.14 sets out a procedure for independent and disinterested directors to conduct an investigation and decide whether the derivative claim is in the best interests of the corporation. If they determine in good faith that it is not, the court must dismiss the suit over the plaintiff’s objection. It would be hard to imagine requiring these procedures, especially in cases like this one involving an imminent corporation merger, at the instance of someone who could in no event file suit.

Finally, we are concerned with the potential for abuse if demands can be sent without identifying any shareholder. The letter here was on the letterhead of a California law firm whose principal prosecuted hundreds of stockholder derivative actions, and later pleaded guilty to paying kickbacks to shareholders recruited for that purpose.

* * *

The only complaint and demand for action listed in this letter was that the Board stop the Hoshizaki merger “in light of a superior offer ... at \$23 per share.” The demand gives no reason why the Hoshikazi offer was inferior other than what one can imply from the \$1 difference in price. All other things being equal, shareholders should of course prefer \$1 more rather than \$1 less. But in comparing competing offers for a merger, all other things are rarely equal.

A large number of variables may affect the inherent value of competing offers for corporate stock. A cash offer may prove more or less valuable than an offer of stock currently valued at the same amount. Competing bidders may be more or less capable of funding the offers they tender, or completing the transaction without anti-trust or other obstacles. Competitors may attach conditions that make an offer more or less attractive in the short or long run.

In a merger like this involving several hundred million dollars, one cannot say whether the \$23 offer was superior to the \$22 offer without knowing a lot more. A rule requiring that a corporation always accept nominally higher offers, in addition to sometimes harming shareholders, would replace the business judgment that Texas law requires a board of directors to exercise. As a result, a board cannot analyze a shareholder’s complaint about a higher competing offer without knowing the basis of that complaint. As this demand said nothing about that, it was not stated “with particularity” as required by article 5.14.

The second sentence of the demand here added that the Board should “fully and fairly consider all potential offers” and “disclose to shareholders all of your analysis” for recommending the Hosizaki sale. This bland statement of a corporate board’s duties could be sent to any board at any time on any issue. The demand did not suggest how the board had failed to consider other offers, or what information it might be withholding. Thus, it gives no direction about what Lancer’s board should have done here.

* * *

Whether a demand is specific enough will depend on the circumstances of the corporation, the board, and the transaction involved in the complaint. But given the size of this corporation and the nature of this transaction, this demand was clearly inadequate.

(2) Texas Distinguishes Between Public and Private Entities. While Delaware does not distinguish between public and private entities in respect of derivative claims, the Tex. Corp. Stats. provide that their demand and dismissal provisions are not applicable to “closely held corporations” (defined as those with less than 35 shareholders and no public market).⁵⁰⁹ TBOC § 21.563 provides:

Section 21.563. Closely Held Corporation. (a) In this section, “closely held corporation” means a corporation that has:

- (1) fewer than 35 shareholders; and
- (2) no shares listed on a national securities exchange or regularly quoted in an over-the-counter market by one or more members of a national securities association.

(b) Sections 21.552-21.559 do not apply to a closely held corporation.

(c) If justice requires:

(1) a derivative proceeding brought by a shareholder of a closely held corporation may be treated by a court as a direct action brought by the shareholder for the shareholder's own benefit; and

(2) a recovery in a direct or derivative proceeding by a shareholder may be paid directly to the plaintiff or to the corporation if necessary to protect the interests of creditors or other shareholders of the corporation.⁵¹⁰

Even though the demand and related dismissal provisions of the Tex. Corp. Stats. are not by their terms applicable to closely held corporations (as defined in TBOC § 21.563), a corporation could nevertheless argue that a similar result could be obtained by virtue of the inherent power of an independent and disinterested Board to determine whether a corporation should pursue any litigation.⁵¹¹

TBOC § 21.563, however, provides that the TBOC’s derivative action demand and dismissal provisions, which are intended to give a corporation’s Board the opportunity to delay and perhaps dismiss derivative proceedings, are not applicable to closely held corporations.⁵¹² Just as the TBOC’s demand and mandatory dismissal requirements do not apply to shareholder derivative lawsuits brought on behalf of closely held corporations, Texas law does “not require shareholders of a closely held corporation to establish derivative standing by pleading or proving that the directors failed to exercise their honest business judgment in not pursuing the corporate

⁵⁰⁹ See *Webre v. Sneed*, 358 S.W.3d 322, 334 (Tex. App.—Houston [1st Dist.] 2011, pet. granted), later proceeding at 2014 Tex. LEXIS 779 (Aug. 29, 2014).

⁵¹⁰ TBCA art. 5.14 is substantively identical to TBOC § 21.563.

⁵¹¹ See *supra* notes 258, 491-492 and related text.

⁵¹² TBOC § 21.563(a) defines “closely held corporation” to mean a corporation with less than 35 shareholders and no public market.

cause of action.”⁵¹³ A shareholder of a closely held corporation is not required to plead and prove that the Board acted outside of the protections of the business judgment rule in deciding not to pursue the corporation’s cause of action.⁵¹⁴

TBOC § 21.563 further provides that if justice requires: (1) a derivative proceeding brought by a shareholder of a closely held corporation may be treated by a court as a direct action brought by the shareholder for the shareholder’s own benefit; and (2) a recovery in a direct or derivative proceeding by a shareholder of a closely held corporation may be paid directly to the plaintiff or to the corporation if necessary to protect the interests of creditors or other shareholders of the corporation.

In *Ritchie v. Rupe*, the Supreme Court explained:

Even when a closely held corporation does not elect to operate as a “close corporation,”⁵¹⁵ the Legislature has enacted special rules to allow its shareholders to more easily bring a derivative suit on behalf of the corporation. Shareholders in a closely held corporation, for example, can bring a derivative action without having to prove that they “fairly and adequately represents the interests of” the corporation ..., without having to make a “demand” upon the corporation, as in other derivative actions, and without fear of a stay or dismissal based on actions of other corporate actors in response to a demand. And when justice requires, the court may treat a derivative action on behalf of a closely held corporation “as a direct action brought by the shareholder for the shareholder’s own benefit,” and award any recovery directly to that shareholder.⁵¹⁶

Thus, the concept that fiduciary duty claims are derivative should not prevent shareholder plaintiffs from recovering directly on a fiduciary duty claim, just as they could on a shareholder oppression action.

(3) Texas Double Derivative Actions. A shareholder of a closely held Texas parent corporation may assert a derivative lawsuit on behalf of the parent corporation’s wholly owned subsidiary against the subsidiary’s directors and officers for breach of fiduciary duties (a “Double Derivative Action”).⁵¹⁷

⁵¹³ *Sneed v. Webre*, 465 S.W.3d 169, 183 (Tex. 2015).

⁵¹⁴ *Id.* at 193.

⁵¹⁵ See TBOC §§ 21.701-21.763 regarding “close corporations.” A Texas corporation elects “close corporation” status by including a provision to such effect in its certificate of formation, and may provide in such document or in a shareholder agreement, which can be similar to a partnership agreement, that management will be by a board of directors or by the shareholders. TBOC §§ 3.008, 21.703, 21.713. Under TBOC § 21.101, any Texas corporation (except a corporation whose shares are publicly traded) may modify how the corporation is to be managed and operated, in much the same way as a close corporation, by an agreement set forth in (1) the certificate of formation or the bylaws approved by all of the shareholders or (2) a written agreement signed by all of the shareholders. Under TBOC § 21.101(b), the agreement is not required to be filed with the Secretary of State unless it is part of the certificate of formation.

⁵¹⁶ *Ritchie v. Rupe*, 443 S.W.3d at 880-81.

⁵¹⁷ *Sneed v. Webre*, 465 S.W.3d 169 (Tex. 2015).

(c) Delaware Derivative Actions.

(1) Demand; Futility. In Delaware, “in order to cause the corporation to pursue [derivative] litigation, a shareholder must either (1) make a pre-suit demand by presenting the allegations to the corporation’s directors, requesting that they bring suit, and showing that they wrongfully refused to do so, or (2) plead facts showing that demand upon the board would have been futile.”⁵¹⁸ If the “plaintiff does not make a pre-suit demand on the board of directors, the complaint must plead with particularity facts showing that a demand on the board would have been futile.”⁵¹⁹ This “demand requirement is not to insulate defendants from liability; rather, the demand requirement and the strict requirements of factual particularity under Rule 23.1 ‘exist[] to preserve the primacy of board decisionmaking regarding legal claims belonging to the corporation.’”⁵²⁰

Under the test articulated by the Delaware Supreme Court in *Aronson v. Lewis*, “to show demand futility, plaintiffs must provide particularized factual allegations that raise a reasonable doubt that ‘(1) the directors are disinterested and independent [or] (2) the challenged transaction was otherwise the product of a valid exercise of business judgment.’”⁵²¹

⁵¹⁸ *In re Citigroup Inc. S’holder Derivative Litig.*, 964 A.2d 106, 120 (Del. Ch. 2009).

⁵¹⁹ *Id.*

⁵²⁰ *Id.*

⁵²¹ 473 A.2d 805, 814 (Del. 1984). *See In re Tyson Foods, Inc. Consolidated Shareholder Litigation*, 919 A.2d 563, 581-82 (Del. Ch. 2007):

The first hurdle facing any derivative complaint is [Delaware Chancery] Rule 23.1, which requires that the complaint “allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors . . . and the reasons for the plaintiff’s failure to obtain the action or for not making the effort.” Rule 23.1 stands for the proposition in Delaware corporate law that the business and affairs of a corporation, absent exceptional circumstances, are to be managed by its board of directors. To this end, Rule 23.1 requires that a plaintiff who asserts that demand would be futile must “comply with stringent requirements of factual particularity that differ substantially from the permissive notice pleadings” normally governed by Rule 8(a). Vague or conclusory allegations do not suffice to upset the presumption of a director’s capacity to consider demand. As famously explained in *Aronson v. Lewis*, plaintiffs may establish that demand was futile by showing that there is a reason to doubt either (a) the disinterestedness and independence of a majority of the board upon whom demand would be made, or (b) the possibility that the transaction could have been an exercise of business judgment.

There are two ways that a plaintiff can show that a director is unable to act objectively with respect to a pre-suit demand. Most obviously, a plaintiff can assert facts that demonstrate that a given director is personally interested in the outcome of litigation, in that the director will personally benefit or suffer as a result of the lawsuit in a manner that differs from shareholders generally. A plaintiff may also challenge a director’s independence by alleging facts illustrating that a given director is dominated through a “close personal or familial relationship or through force of will,” or is so beholden to an interested director that his or her “discretion would be sterilized.” Plaintiffs must show that the beholden director receives a benefit “upon which the director is so dependent or is of such subjective material importance that its threatened loss might create a reason to question whether the director is able to consider the corporate merits of the challenged transaction objectively.”

See also Ryan v. Gifford, 918 A.2d 341, 351-53 (Del. Ch. 2007), for further elaboration on demand futility as follows:

Where plaintiffs do not challenge a specific decision of the Board and instead complain of Board inaction, there is no challenged action, and the traditional *Aronson v. Lewis* analysis does not apply.⁵²² In an inaction case, “to show demand futility where the subject of the derivative suit is not a business decision of the Board, the plaintiff must allege particularized facts that ‘create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand.’”⁵²³

Demand futility is not shown solely because all of the directors are defendants in the derivative action and the directors would be deciding to sue themselves.⁵²⁴ “Rather, demand will be excused based on a possibility of personal director liability only in the rare case when a

Defendants state that plaintiff has failed to make demand or prove demand futility. That is, defendants contend that the complaint lacks particularized facts that either establish that a majority of directors face a “substantial likelihood” of personal liability for the wrongdoing alleged in the complaint or render a majority of the board incapable of acting in an independent and disinterested fashion regarding demand.

When a shareholder seeks to maintain a derivative action on behalf of a corporation, Delaware law requires that shareholder to first make demand on that corporation’s board of directors, giving the board the opportunity to examine the alleged grievance and related facts and to determine whether pursuing the action is in the best interest of the corporation. This demand requirement works “to curb a myriad of individual shareholders from bringing potentially frivolous lawsuits on behalf of the corporation, which may tie up the corporation’s governors in constant litigation and diminish the board’s authority to govern the affairs of the corporation.”

This Court has recognized, however, that in some cases demand would prove futile. Where the board’s actions cause the shareholders’ complaint, “a question is rightfully raised over whether the board will pursue these claims with 100% allegiance to the corporation, since doing so may require that the board sue *itself* on behalf of the corporation.” Thus, in an effort to balance the interest of preventing “strike suits motivated by the hope of creating settlement leverage through the prospect of expensive and time-consuming litigation discovery [with the interest of encouraging] suits reflecting a reasonable apprehension of actionable director malfeasance that the sitting board cannot be expected to objectively pursue on the corporation’s behalf,” Delaware law recognizes two instances where a plaintiff is excused from making demand. Failure to make demand may be excused if a plaintiff can raise a reason to doubt that: (1) a majority of the board is disinterested or independent or (2) the challenged acts were the product of the board’s valid exercise of business judgment.

The analysis differs, however, where the challenged decision is not a decision of the board in place at the time the complaint is filed. * * * Accordingly, where the challenged transaction was not a decision of the board upon which plaintiff must seek demand, plaintiff must “create a reasonable doubt that, as of the time the complaint is filed, the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand.”

* * * Where at least one half or more of the board in place at the time the complaint was filed approved the underlying challenged transactions, which approval may be imputed to the entire board for purposes of proving demand futility, [demand may be excused].

⁵²² *Rales v. Blasband*, 634 A.2d 927, 933-34 (Del. 1993); *In re Citigroup Inc. S’holder Derivative Litig.*, 964 A.2d 106, 120 (Del. Ch. 2009).

⁵²³ *Citigroup*, 964 A.2d at 120; *see also In re The Goldman Sachs Group, Inc. Shareholder Litigation*, C.A. No. 5215-VCG, 2011 Del. Ch. LEXIS 151, at *21 (Del. Ch. Oct. 12, 2011).

⁵²⁴ *In re Affiliated Computer Servs., Inc. S’holders Litig.*, C.A. No. 2821-VCL, 2009 WL 296078, at *7 (Del. Ch. Feb. 6, 2009); *Citigroup*, 964 A.2d at 120.

plaintiff is able to show director conduct that is ‘so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability therefore exists.’”⁵²⁵ In a derivative action in a Texas court involving a Delaware corporation, under the internal affairs doctrine Delaware law governs standing and whether demand is excused because it would be futile.⁵²⁶

In Delaware, a derivative plaintiff must have been a stockholder continuously from the time of the transaction in question through the completion of the lawsuit.⁵²⁷ Stockholders who obtained their shares in a merger lack derivative standing to challenge pre-merger actions.⁵²⁸

(2) Delaware Double Derivative Actions. In contrast to a standard derivative action in which a shareholder brings a lawsuit asserting a claim belonging to a corporate entity in which the shareholder owns shares, a Double Derivative Action involves two entities: the corporation whose claim is being asserted (“corporation A”), and the corporation which owns or controls corporation A.⁵²⁹ In *Lambrecht v. O’Neal*,⁵³⁰ the essence of a Double Derivative Action in Delaware was summarized by the Delaware Supreme Court as follows:

* * *

Thus, by its nature a double derivative suit is one brought by a shareholder of a parent corporation to enforce a claim belonging to a subsidiary that is either wholly owned or majority controlled. Normally, such a claim is one that only the parent corporation, acting through its board of directors, is empowered to enforce. Cases may arise, however, where the parent corporation’s board is shown to be incapable of making an impartial business judgment regarding whether to assert the subsidiary’s claim. In those cases a shareholder of the parent will be permitted

⁵²⁵ *Citigroup*, 964 A.2d at 121 (quoting *Aronson v. Lewis*, 473 A.2d 805, 815 (Del. 1984)).

⁵²⁶ *In re Brick*, 351 S.W.3d 601, 603 (Tex. App.—Dallas 2011, no pet.) (the Dallas Court of Appeals granted a writ of mandamus holding that the trial court erred in denying the directors’ “special exceptions” (that is, its challenges as to whether the shareholders’ allegations “stated a cause of action under applicable law”) because the shareholders failed to demonstrate that each individual director acted in a way not protected by the business judgment rule as required under Delaware law, which was applicable because Texas follows the internal affairs doctrine). *See supra* notes 264-270 regarding the internal affairs doctrine.

⁵²⁷ *Ryan v. Gifford*, 918 A.2d at 359; DGCL § 327 (2013).

⁵²⁸ *Cf. La. Mun. Police Employees’ Ret. Sys. v. Crawford*, 918 A.2d 1172, 1185 (Del. Ch. 2007) and *Express Scripts, Inc. v. Crawford*, 918 A.2d 1172, 1178 (Del. Ch. 2007) (delaying a stockholders meeting to vote on the proposed Caremark Rx/CVS merger from February 20, 2007 to March 9, 2007 to allow disclosures that (i) Caremark had three times discussed a possible transaction with Express Scripts even though after its agreement with CVS, Caremark was arguing that antitrust concerns even precluded talking to this higher bidder, and (ii) any merger of Caremark could cause other plaintiffs to lose standing to sue Caremark Rx directors for breach of fiduciary duty in respect of alleged options backdating; *but cf. In re CheckFree Corp.*, No. 3193-CC, 2007 WL 3262188, at *4 (Del. Ch. Nov. 1, 2007) (denying a claim that management failed to disclose the effect of a merger on a pending derivative action and that the merger would likely extinguish the claim and free one of the directors from liability, holding that “directors need not [give legal advice and] tell shareholders that a merger will extinguish pending derivative claims”). Though such information may be helpful in an abstract sense, the Court found it unlikely the disclosure would “alter the total mix of information available.” *Id.*

⁵²⁹ *See supra* note 517 regarding Double Derivative Actions under Texas law.

⁵³⁰ 3 A.3d 277, 281 (Del. 2010).

to enforce that claim on the parent corporation's behalf, that is, double derivatively.

Double derivative actions generally fall into two distinct categories. The first are lawsuits that are brought originally as double-derivative actions on behalf of a parent corporation that has a pre-existing, wholly owned subsidiary at the time of the alleged wrongful conduct at the subsidiary level. In this category, no intervening merger takes place. The second category involves cases, such as this, where the action is brought originally as a standard derivative action on behalf of a corporation that thereafter is acquired by another corporation in an intervening stock-for-stock merger. We distinguish these two categories because they create different standing (and pre-suit demand) issues.

In the first category—cases where the wholly-owned subsidiary pre-existed the alleged wrongdoing and where no intervening merger took place—corporation A is already a subsidiary of corporation B at the time of the alleged wrongdoing at corporation A. In those cases, only the parent corporation owns the subsidiary's stock at the time of the alleged wrongdoing, and the plaintiff owns stock only in the parent. Therefore, a Rule 23.1 demand could only be made—and a derivative action could only be brought—at the parent, not the subsidiary, level.

* * *

The second category involves actions brought derivatively on behalf of a corporation that was originally a stand-alone entity but where, as a result of being acquired in a later stock-for-stock merger, (1) the acquired corporation became a wholly-owned subsidiary of the acquiring corporation and (2) the shareholders of the (pre-merger) entity became shareholders of the acquiring corporation. * * * What materially differentiates the second category from the first is that in this second category, as a matter of law the merger operates to divest the original shareholder plaintiff of standing to maintain the standard derivative action brought originally on behalf of the acquired corporation. That result, in turn, creates issues relating to whether—and, if so, in what circumstances—the original stockholder plaintiff, as a newly incarnated shareholder of the acquirer-parent corporation can have standing to assert the (now wholly-owned) subsidiary's claim double-derivatively. That brings us to the second subject of this preliminary sketch of the current legal roadmap: standing.

(2) Standing To Sue Double Derivatively

The standing issue is a consequence of the doctrine articulated in *Lewis v. Anderson*.⁵³¹ There, a standard derivative action was brought in the Court of Chancery on behalf of Conoco Inc. (Old Conoco) charging its directors with breaches of fiduciary duty. Thereafter, and while that action was pending, E.I.

⁵³¹ 477 A.2d 1040, 1041 (Del. 1984).

duPont de Nemours, Inc. (DuPont) acquired Old Conoco in a stock-for-stock merger. As a result, Old Conoco disappeared and the surviving corporation—a wholly owned subsidiary of DuPont—was renamed Conoco, Inc. (New Conoco). After the merger, the defendants moved to dismiss the derivative action, arguing that the plaintiff had lost his standing to maintain it because as a matter of law the derivative claim became the property of New Conoco, which post-merger was the only party with standing to assert the claim. The Court of Chancery dismissed the action, and this Court affirmed. The reasoning which supports that outcome is critical to understanding how the standing issue arises in the double derivative context.

The *Anderson* court, citing earlier Delaware decisions, held that for a shareholder to have standing to maintain a derivative action, the plaintiff “must not only be a stockholder at the time of the alleged wrong and at the time of commencement of suit but...must also maintain shareholder status throughout the litigation.” These two imperatives are referred to, respectively, as the “contemporaneous ownership” and the “continuous ownership” requirements. The contemporaneous ownership requirement is imposed by statute; while the continuous ownership requirement is a creature of common law. *Lewis v. Anderson* holds that where the corporation on whose behalf a derivative action is pending is later acquired in a merger that deprives the derivative plaintiff of his shares, the derivative claim—originally belonging to the acquired corporation—is transferred to and becomes an asset of the acquiring corporation as a matter of statutory law. Because as a consequence the original derivative shareholder plaintiff can no longer satisfy the continuous ownership requirement, the plaintiff loses standing to maintain the derivative action. And, because the claim is now (post merger) the property of the acquiring corporation, that corporation is now the only party with standing to enforce the claim, either by substituting itself as the plaintiff or by authorizing the original plaintiff to continue prosecuting the suit on the acquiring company’s behalf.

That rationale generates the question presented here, which may be stated thusly: where a shareholder has lost standing to maintain a standard derivative action by reason of an acquisition of the corporation in a stock-for-stock merger, may that shareholder, in his new capacity as a shareholder of the acquiring corporation, assert the claim double derivatively and, if so, what requirements must the plaintiff satisfy?

* * *

In *Rales v. Blasband* we held that the traditional *Aronson v. Lewis* demand excusal test would not be employed in considering whether a demand on the parent board was required in a double derivative action. Rather, a different test (the “*Rales* test”) would apply, which is whether the particularized factual allegations of the complaint create a reasonable doubt that the parent’s board of directors could properly have exercised its independent and disinterested business judgment in responding to a demand. This Court further held that in a double

derivative action the *Rales* test would apply as of the time the complaint was filed, as distinguished from the time of the alleged wrongdoing.

The underlying actions in *Lambrecht* began as standard derivative lawsuits, filed on behalf of Merrill Lynch & Co., Inc., to recover for purported breaches of fiduciary duties by Merrill Lynch officers and directors prior to its acquisition by Bank of America Corporation's in a stock-for-stock merger. Following the merger, BofA and Merrill Lynch moved to dismiss the two pending derivative actions on the ground that the plaintiffs, who were no longer stockholders of Merrill Lynch by virtue of the merger, had lost their standing to assert derivative claims on behalf of Merrill Lynch. The Southern District Court of New York granted the motions but, in dismissing the actions without prejudice, allowed the plaintiffs to replead their claims as "double derivative" actions (i.e., actions to enforce a claim of Merrill Lynch through BofA). The defendants again moved to dismiss plaintiffs' claims for lack of standing, arguing that in order to have standing to sue double derivatively, the plaintiffs had to be able to demonstrate that: (i) they were (and remain) stockholders of BofA *both* after the merger and also at the time of the alleged fiduciary misconduct prior to the merger; and (ii) BofA itself was a stockholder of Merrill Lynch at the time of the alleged fiduciary misconduct prior to the merger. Following oral argument, the Southern District certified the following question to the Delaware Supreme Court:

Whether plaintiffs in a double derivative action under Delaware law, who were pre-merger shareholders in the acquired company and who are current shareholders, by virtue of a stock-for-stock merger, in the post-merger parent company, must also demonstrate that, at the time of the alleged wrongdoing at the acquired company, (a) they owned stock in the acquiring company, and (b) the acquiring company owned stock in the acquired company.

The Delaware Supreme Court ultimately concluded that the certified question must be answered in the negative.⁵³² The Supreme Court concluded that a "post-merger double derivative action is not a *de facto* continuation of the pre-merger derivative action" but instead "a new, distinct action in which standing to sue double derivatively rests on a different temporal and factual basis—namely, the failure of the BofA board, post-merger, to enforce the pre-merger claim of its wholly-owned subsidiary."

(d) Federal Rules of Civil Procedure. Federal Rule of Civil Procedure 23.1 also provides that a plaintiff may bring a shareholder derivative suit if the requirements for Federal Court jurisdiction are satisfied and the following additional two requirements are met: (1) the plaintiff must have owned shares in the corporation at the time of the disputed transaction; and (2) the plaintiff must allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors.⁵³³ Case law further requires that the plaintiff

⁵³² In so ruling, the Supreme Court overruled the Court of Chancery's decision in *Saito v. McCall*, No. 17132-NC, 2004 WL 3029876 (Del. Ch. Dec. 20, 2004), to the extent it is inconsistent with the Supreme Court's reasoning and conclusions set forth in its opinion in *Lambrecht v. O'Neal*.

⁵³³ FED. R. CIV. P. 23.1.

remain a shareholder throughout the course of the derivative action.⁵³⁴ This demand requirement may be excused if the facts show that demand would have been futile.⁵³⁵

(e) Effect of Merger on Derivative Claims. Questions arise with respect to the effect of a merger in which the corporation is not the acquiring entity on a derivative action. Under Delaware law, in the absence of fraud, “the effect of a merger . . . is normally to deprive a shareholder of the merged corporation of standing to maintain a derivative action.”⁵³⁶ Allegations that a Board Chairman foiled a potential superior bid by demanding a position for himself with the superior bidder (an entrenchment claim) were derivative in nature and did not survive a merger with another bidder.⁵³⁷ A narrow exception to Delaware’s general non-survival

⁵³⁴ See *infra* note 540 and related text.

⁵³⁵ *Potter v. Hughes*, 546 F.3d 1051, 1056 (9th Cir. 2008).

⁵³⁶ *Arkansas Teacher Retirement System v. Countrywide Financial Corporation*, 75 A.3d 888, 894 (Del. 2013) (in a derivative action, the plaintiff must be a stockholder at the time of the alleged wrong (the “contemporaneous ownership” requirement, which is imposed by DGCL § 327) and must maintain that stockholder status throughout the litigation (the “continuous ownership” requirement, which is a matter of common law; an exception exists where the merger was being perpetrated merely to deprive stockholders of standing to bring a derivative action); *Feldman v. Cutaia*, 951 A.2d 727, 728 (Del. 2008) (claim by shareholder that invalid grant of options resulted in dilution, which resulted in shareholder getting less value in merger, was derivative and did not survive merger); *Lewis v. Ward*, 852 A.2d 896, 897 (Del. 2004); *Lewis v. Anderson*, 477 A.2d 1040, 1047–49 (Del. 1984); *In re Merrill Lynch & Co., Inc. Sec., Derivative and ERISA Litig.*, 597 F. Supp. 2d 427 (S.D.N.Y. Feb. 17, 2009); *Binks v. DSL.net, Inc.*, C.A. No. 2823-VCN, 2010 Del. Ch. LEXIS 98, at *2 (Del. Ch. April 29, 2010) (mem. op.); *Schreiber v. Carney*, 447 A.2d 17, 21 (Del. Ch. 1982) (“[A] merger which eliminates a complaining stockholder’s ownership of stock in a corporation also ordinarily eliminates his status to bring or maintain a derivative suit on behalf of the corporation, whether the merger takes place before or after the suit is brought, on the theory that upon the merger the derivative rights pass to the surviving corporation which then has the sole right or standing to prosecute the action.”); see *Elloway v. Pate*, 238 S.W.3d 882, 900 (Tex. App.—Houston [14th Dist.] 2007, no pet.), in which a Texas court applying Delaware law held that a merger eliminated standing to bring a derivative action, but not a direct action, and explained: “A derivative claim is brought by a stockholder, on behalf of the corporation, to recover harm done to the corporation. *Tooley v. Donaldson, Lufkin & Jenrette*, 845 A.2d 1031, 1036 (Del. 2004). A stockholder’s direct claim must be independent of any alleged injury to the corporation. *Id.* at 1039. If the stockholder’s claim is derivative, the stockholder loses standing to pursue his claim upon accomplishment of the merger. *Parnes v. Bally Entm’t Corp.*, 722 A.2d 1243, 1244-45 (Del. 1999). A stockholder who directly attacks the fairness or validity of a merger alleges an injury to the stockholders, not the corporation, and may pursue such claim even after the merger at issue has been consummated. *Id.* at 1245. To state a direct claim with respect to a merger, a stockholder must challenge the validity of the merger itself, usually by charging the directors with breaches of fiduciary duty in unfair dealing and/or unfair price. *Id.* at 1245.” Cf. *Pate v. Elloway*, No. 01-03-00187-CV, 2003 WL 22682422, at *1 (Tex. App.—Houston [1st Dist.] Nov. 13, 2003, pet. denied); *Grosset v. Wenaas*, 175 P.3d 1184, 1197 (Cal. 2008) (in holding that a derivative lawsuit for breaches of fiduciary duty and insider trading in connection with a secondary offering by the corporation did not survive a reverse triangular merger in which it was the surviving corporation, the California Supreme Court wrote: “[W]e hold that California law, like Delaware law, generally requires a plaintiff in a shareholder’s derivative suit to maintain continuous stock ownership throughout the pendency of the litigation. Under this rule, a derivative plaintiff who ceases to be a stockholder by reason of a merger ordinarily loses standing to continue the litigation. Although equitable considerations may warrant an exception to the continuous ownership requirement if the merger itself is used to wrongfully deprive the plaintiff of standing, or if the merger is merely a reorganization that does not affect the plaintiff’s ownership interest, we need not address such matters definitively in this case, where no such circumstances appear.”).

⁵³⁷ *In re NYMEX Shareholder Litigation*, C.A. No. 3621-VCN, 2009 Del. Ch. LEXIS 176, at *35 (Del. Ch. Sept. 30, 2009).

rule exists: a “stockholder who directly attacks the fairness or validity of a merger alleges an injury to the stockholders, not the corporation, and may pursue such a claim even after the merger at issue has been consummated.”⁵³⁸ As the extinguishment of a derivative claim can have value to those who would benefit therefrom, the Board should consider (i) the value (if any) of the extinguishment as it seeks to maximize the value of the corporation in the merger, (ii) whether any of the directors has a conflict of interest relative to the derivative claims, and (iii) whether its financial adviser should address such value (if any) in its fairness opinion and related analyses.⁵³⁹

The effect of a merger in which the corporation is not the acquiring entity on a derivative action was not as clear under Texas law until 2011. Like Delaware’s rules, the Federal Rules of Civil Procedure⁵⁴⁰ and Texas’ prior derivative action provisions in the TBCA⁵⁴¹ have been

⁵³⁸ *Parnes v. Bally Entm’t Corp.*, 722 A.2d 1243, 1245 (Del. 1999).

⁵³⁹ *See In re Primedia, Inc. S’holders Litig. (Primedia III)*, Consolidated C.A. No. 6511-VCL, 2013 Del. Ch. LEXIS 306, at *3 (Del. Ch. Dec. 20, 2013) (motion to dismiss denied as to claims for breach of fiduciary duty on the ground that the merger was not entirely fair in light of *Brophy* insider trading claims involving directors and a controlling stockholder who would benefit from extinguishment of derivative claims in the merger); *Gerber v. Enter. Prods. Hldgs., LLC*, 67 A.3d 400 (Del. June 10, 2013) (duty of good faith and fair dealing required that the fairness opinion “address the value of derivative claims where (as here) terminating those claims was a principal purpose of a merger”); and *In re Massey Energy Derivative and Class Action Litigation*, C.A. No. 5430-VCS, 2011 Del. Ch. LEXIS 83 (Del. Ch. May 31, 2011) (merger not enjoined as Court found that, while it was regrettable that the independent directors did not all understand that control of derivative claims against the directors would pass to the buyer in the merger, the independent directors ran a fair process to maximize the value of the corporation and did not approve the merger to escape personal liability; further, the Court thought it unlikely that the buyer ascribed any material value to the derivative claims, and concluded that the merger proxy statement disclosures regarding the passing of control of the derivative claims to buyer was adequate and the stockholders (largely institutions) could decide whether they were better off approving the merger or continuing to hold their stock with the attendant derivative claims).

⁵⁴⁰ FED. R. CIV. P. 23.1; *Schilling v. Belcher*, 582 F.2d 995, 999 (5th Cir. 1978) (noting “the [stock] ownership requirement continues throughout the life of the suit”); *Romero v. US Unwired, Inc.*, No. 04-2312, 2006 WL 2366342, at *5 (E.D. La. Aug. 11, 2006) (slip op.) (holding that merger divested shareholder plaintiff of standing to pursue derivative claim under Fed. R. Civ. P. 23.1 and dismissing suit); *Quinn v. Anvil Corporation*, 620 F.3d 1005, 1012 (9th Cir. 2010) (holding that because of the extraordinary nature of a shareholder derivative suit, FRCP 23.1 establishes two stringent conditions for bringing such a suit: First, plaintiffs must comply with Rule 23.1’s pleading requirements, including that the plaintiff “allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors;” Second, under Rule 23.1 (a) a derivative action “may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of shareholders or members who are similarly situated in enforcing the right of the corporation or association,” from which courts have inferred a requirement not only “that a derivative plaintiff be a shareholder at the time of the alleged wrongful acts” but also “that the plaintiff retain ownership of the stock for the duration of the lawsuit” (the so-called “continuous ownership requirement”) so that “if a shareholder is divested of his or her shares during the pendency of litigation, that shareholder loses standing” and as a result plaintiff’s derivative action was foreclosed by operation of the reverse stock split in which plaintiff’s shares were cancelled and plaintiff thereafter held no stock; plaintiff’s derivative claims are an “intangible asset” belonging to the corporation, not to plaintiff and plaintiff as a nonshareholder cannot benefit from any recovery the company obtains; equitable exceptions to the continuous ownership requirement were not applicable because (i) there were other shareholders who could have brought the claim and the challenged transaction did not result in a dissolution of the corporation leaving no continuing shareholders as in the case of some mergers and (ii) there was a valid business purpose (consolidating stock ownership in employees for benefit of the

interpreted to require that the claimant in a derivative case remain a shareholder throughout the course of the derivative claim, which requirement would not be satisfied where a derivative plaintiff's shares in the corporation are converted in the merger into cash or securities of another entity. Only one Texas court has ruled on the merger survival issue under the derivative provisions in the pre-2011 Tex. Corp. Stats., holding that, at least in a cash-out merger, the right of a shareholder to bring a derivative action on behalf of the non-surviving corporation does not survive the merger.⁵⁴² In the 2011 Texas Legislature Session, the TBOC was amended to clarify that a plaintiff in a corporate shareholder derivative suit must have been a shareholder at the time of filing suit through completion of the proceedings, and thus would not have standing to be a derivative plaintiff if his shares were converted to cash in a merger.⁵⁴³ Although Delaware law

corporation for the transaction) and no evidence beyond plaintiff's self serving statements that the reverse split was undertaken to cut off plaintiff's derivative claims).

⁵⁴¹ *Zauber v. Murray Sav. Ass'n*, 591 S.W.2d 932, 937-38 (Tex. Civ. App. – Dallas 1979), writ ref'd per curiam, 601 S.W.2d 940 (Tex. 1980) (“The requirement in article [TBCA] 5.14(B) [as it existed in 1979] that in order to bring a derivative suit a plaintiff must have been a shareholder at the time of the wrongful transaction, is only a minimum requirement. The federal rule governing derivative suits, which contains similar requirements to article 5.14(B), has been construed to include a further requirement that shareholder status be maintained throughout the suit. [citations omitted] The reasoning behind allowing a shareholder to maintain a suit in the name of the corporation when those in control wrongfully refuse to maintain it is that a shareholder has a proprietary interest in the corporation. Therefore, when a shareholder sues, he is protecting his own interests as well as those of the corporation. If a shareholder voluntarily disposes of his shares after instituting a derivative action, he necessarily destroys the technical foundation of his right to maintain the action. [citation omitted] If, on the other hand, a shareholder's status is involuntarily destroyed, a court of equity must determine whether the status was destroyed without a valid business purpose; for example, was the action taken merely to defeat the plaintiff's standing to maintain the suit? * * * If no valid business purpose exists, a court of equity will consider the destruction of a stockholder's status a nullity and allow him to proceed with the suit in the name of the corporation. Therefore, on remand of this suit, a finding that appellant has failed to maintain his status as shareholder is dependent upon findings that the disposition of the stock was voluntary or, though involuntary, that the corporation's termination proceeding was instituted to accomplish a valid business purpose, rather than to dispose of the derivative suit by a reverse stock split.”).

⁵⁴² *Somers v. Crane*, 295 S.W.3d 5, 15 (Tex. App.—Houston [1st Dist.] 2009, pet. denied). TBCA art. 5.03(M) provided that for the purposes of TBCA art. 5.03: “To the extent a shareholder of a corporation has standing to institute or maintain derivative litigation on or behalf of the corporation immediately before a merger, nothing in this article may be construed to limit or extinguish the shareholder's standing.” (Substantially the same language was initially included in TBOC § 21.552(b)). At least one federal court interpreting Texas law has suggested that under TBCA art. 5.03(M) a shareholder who could have properly brought a derivative suit prior to a merger will maintain that right, even after a merger has rendered the corporation in question nonexistent. *Marron v. Ream*, Civil Action No. H-06-1394, 2006 U.S. Dist. LEXIS 72831, at *23 (S.D. Tex. May 8, 2006). But the *Somers* opinion dismissed this analysis, holding that *Marron* did not squarely address the issue of standing and that the federal court's suggestion that 5.03(M) might support survival was merely dicta. *Somers*, No. 01-08-00119-CV at 21. *Somers* also held that “because of the abundant authority stating that a director's or officer's fiduciary duty runs only to the corporation, not to individual shareholders, we decline to recognize the existence of a fiduciary relationship owed directly by a director to a shareholder in the context of a cash-out merger” and, thus, that a direct class action could not be brought against directors and officers for their role in a cash-out merger. *Id.* at 13.

⁵⁴³ S.B. 1568 (available at <http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=82R&Bill=SB1568>) in the 2011 Texas Legislature Session by Sen. Craig Estes clarified that a derivative plaintiff must own stock at the time of filing the derivative action and continuously to the completion of the action by deleting TBOC § 21.552(b) effective September 1, 2011. S.B. 1568 provided:

SECTION 1. Section 21.552, Business Organization Code, is amended read as follows:

explicitly allows for direct suit in some fiduciary duty cases,⁵⁴⁴ *Gearhart* held that under Texas law fiduciary claims in connection with a merger are the right of the corporation itself, not individual shareholders.⁵⁴⁵

(f) Special Litigation Committees. In *Zapata Corporation v. Maldonado*,⁵⁴⁶ the Delaware Supreme Court established a two-step analysis that must be applied to a motion to dismiss a derivative claim based on the recommendation of a Special Litigation Committee (“*SLC*” or a “*Zapata Committee*”) established by a Board in a demand-excused case. The first step of the analysis is a court review of the independence of SLC members and whether the SLC conducted a good faith investigation of reasonable scope that yielded reasonable bases supporting its conclusions.⁵⁴⁷ The second step of the analysis is the Court applying its own business judgment to the facts to determine whether the corporation’s best interests would be served by dismissing the suit, and it is a discretionary step designed for situations in which the technical requirements of step one are met but the result does not appear to satisfy the spirit of the requirements.⁵⁴⁸

The court treats the SLC’s motion in a manner similar to a motion for summary judgment. The SLC bears the burden of demonstrating that there are no genuine issues of material fact as to its independence, the reasonableness and good faith of its investigation and that there are reasonable bases for its conclusions.⁵⁴⁹ If the court determines that a material fact is in dispute on any of these issues, it must deny the SLC’s motion to dismiss.⁵⁵⁰ If an SLC’s motion to dismiss is denied, control of the litigation is returned to the plaintiff shareholder.⁵⁵¹

~~(a) A shareholder may not institute or maintain a derivative proceeding unless:~~

~~(1) the shareholder:~~

~~(A) was a shareholder of the corporation at the time of the act or omission complained of; or~~

~~(B) became a shareholder by operation of law from a person that was a shareholder at the time of the act or omission complained of; and~~

~~(2) the shareholder fairly and adequately represents the interests of the corporation in enforcing the right of the corporation.~~

~~(b) To the extent a shareholder of a corporation has standing to institute or maintain a derivative proceeding on behalf of the corporation immediately before a merger, Subchapter J or Chapter 10 may not be construed to limit or terminate the shareholder's standing after the merger.~~

SECTION 2. This Act takes effect September 1, 2011.

⁵⁴⁴ See *supra* notes 410 and 499 and related text.

⁵⁴⁵ *Gearhart Indus., Inc. v. Smith Int’l. Inc.*, 741 F.2d 707, 721 (5th Cir. 1984).

⁵⁴⁶ 430 A.2d 779, 788 (Del. 1981).

⁵⁴⁷ *Id.* at 789.

⁵⁴⁸ *Id.* at 789.

⁵⁴⁹ *Kaplan v. Wyatt*, 484 A.2d 501, 506-507 (Del. Ch. 1984), *aff’d*, 499 A.2d 1184 (Del. 1985).

⁵⁵⁰ *Id.* at 508.

⁵⁵¹ *Id.* at 509.

The *Zapata* test was applied in *London v. Tyrrell*,⁵⁵² in which a two member SLC was found to have failed to show that it was independent and that the scope of its investigation was reasonable. As to independence, the Court stressed that the SLC must carry the burden of “fully convinc[ing] the Court that the SLC can act with integrity and objectivity.” The two member SLC failed because one committee member was the husband of the defendant’s cousin, and the other was a former colleague of the defendant who felt indebted to the defendant for getting him “a good price” in the prior sale of a company. The Court commented that “it will be nigh unto impossible” to show independence where “the SLC member and a director defendant have a family relationship” or where an SLC member “feels he owes something to an interested director.” The Court was also concerned with deposition testimony and notes suggesting that the SLC members viewed their job as “attacking” the plaintiffs’ complaint. As to the SLC’s investigation, the Court found that the SLC wrongly concluded that some claims were barred by the exculpation provision in the corporation’s charter, made key mistakes of fact, and systematically failed to pursue evidence that might suggest liability. Although the Court denied the SLC’s motion to dismiss and authorized the plaintiffs to pursue the action, the Court commented that the SLC process remains “a legitimate mechanism” in Delaware corporate law, and in an appropriate case an SLC can serve the corporate interest by short-circuiting ill-advised litigation and restoring the Board’s management authority to determine corporate litigation policy.

2.6.8. Contractual Limitation of Corporate Fiduciary Duties. Unlike the statutes governing partnerships and LLCs,⁵⁵³ neither the Tex. Corp. Stats. nor the DGCL include provisions generally recognizing the principle of freedom of contract.⁵⁵⁴ The Tex. Corp. Stats. and the

⁵⁵² C.A. No. 3321-CC, 2010 Del. Ch. LEXIS 54, at *40 (Del. Ch. Mar. 11, 2010).

⁵⁵³ See *infra* notes 1127-1138, 1192-1241, and 1326-1361 and related text.

⁵⁵⁴ See Edward P. Welch & Robert S. Saunders, *Freedom and its Limits in the Delaware General Corporation Law*, 33 Del. J. Corp. L. 845 (2008); cf. DEL. CODE ANN. tit. 6, § 18-1101(a)-(f) (2007); cf. E. Norman Veasey & Christine T. Di Guglielmo, *How Many Masters Can a Director Serve? A Look at the Tensions Facing Constituency Directors*, 63 Bus. Law. 761 (May 2008). The Delaware Limited Liability Company Act aggressively adopts a “contractarian approach” (i.e., the bargains of the parties manifested in LLC agreements are to be respected and rarely trumped by statute or common law) and does not have any provision which itself creates or negates Member or Manager fiduciary duties, but instead allows modification of fiduciary duties by an LLC agreement as follows:

18-1101 CONSTRUCTION AND APPLICATION OF CHAPTER AND LIMITED LIABILITY COMPANY AGREEMENT.

(a) The rule that statutes in derogation of the common law are to be strictly construed shall have no application to this chapter.

(b) It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.

(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.

DGCL do, however, allow fiduciary duties or the consequences thereof to be modified by charter provision or contract in some limited circumstances.

(a) Limitation of Director Liability. Both the DGCL and the Tex. Corp. Stats. allow corporations to provide limitations on (or partial elimination of) director liability in relation to the duty of care in their certificates of incorporation. DGCL § 102(b)(7) reads as follows:

102 Contents of Certificate of Incorporation.

* * *

(b) In addition to the matters required to be set forth in the certificate of incorporation by subsection (a) of this section, the certificate of incorporation may also contain any or all of the following matters:

* * *

(7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) for any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit. No such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective. All references in this paragraph to a director shall

(d) Unless otherwise provided in a limited liability company agreement, a member or manager or other person shall not be liable 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 for breach of fiduciary duty for the member's or manager's or other person's good faith reliance on the provisions of the limited liability company agreement.

(e) A limited liability company agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a member, manager or other person 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; provided, that a limited liability company agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.

(f) Unless the context otherwise requires, as used herein, the singular shall include the plural and the plural may refer to only the singular. The use of any gender shall be applicable to all genders. The captions contained herein are for purposes of convenience only and shall not control or affect the construction of this chapter.

DLLCA §§ 18-1101(a)-(f) are counterparts of, and virtually identical to, §§ 17-1101(a)-(f) of the Delaware Revised Limited Partnership Act. *See* DEL. CODE ANN. tit. 6, § 17-1101 (2007). Thus, Delaware cases regarding partner fiduciary duties should be helpful in the LLC context.

also be deemed to refer (x) to a member of the governing body of a corporation which is not authorized to issue capital stock, and (y) to such other person or persons, if any, who, pursuant to a provision of the certificate of incorporation in accordance with § 141(a) of this title, exercise or perform any of the powers or duties otherwise conferred or imposed upon the board of directors by this title.⁵⁵⁵

DGCL § 102(b)(7) in effect permits a corporation to include a provision in its certificate of incorporation limiting or eliminating a director's personal liability for monetary damages for breaches of the duty of care.⁵⁵⁶ The liability of directors may not be so limited or eliminated, however, in connection with breaches of the duty of loyalty, the failure to act in good faith, intentional misconduct, knowing violations of law, obtaining improper personal benefits, or paying dividends or approving stock repurchases in violation of DGCL § 174.⁵⁵⁷ Delaware courts have routinely enforced DGCL § 102(b)(7) provisions and held that, pursuant to such provisions, directors cannot be held monetarily liable for damages caused by alleged breaches of the fiduciary duty of care.⁵⁵⁸

The Tex. Corp. Stats. contain provisions which are comparable to DGCL § 102(b)(7) and permit a corporation to include a provision in its charter limiting or eliminating a director's personal liability for monetary damages for breaches of the duty of care.⁵⁵⁹

⁵⁵⁵ DGCL § 102(b)(7).

⁵⁵⁶ *Id.*

⁵⁵⁷ *Id.* See also *Zirn v. VLI Corp.*, 621 A.2d 773, 783 (Del. 1993) (holding DGCL § 102(b)(7) provision in corporation's certificate did not shield directors from liability where disclosure claims involving breach of the duty of loyalty were asserted).

⁵⁵⁸ A DGCL § 102(b)(7) provision does not operate to defeat the validity of a plaintiff's claim on the merits, rather it operates to defeat a plaintiff's ability to recover monetary damages. *Emerald Partners v. Berlin*, 787 A.2d 85, 92 (Del. 2001). In determining when a DGCL § 102(b)(7) provision should be evaluated by the Court of Chancery to determine whether it exculpates defendant directors, the Delaware Supreme Court recently distinguished between cases invoking the business judgment presumption and those invoking entire fairness review (these standards of review are discussed below). *Id.* at 92-93. The Court determined that if a stockholder complaint unambiguously asserts solely a claim for breach of the duty of care, then the complaint may be dismissed by invocation of a DGCL § 102(b)(7) provision. *Id.* at 92. The Court held, however, that "when entire fairness is the applicable standard of judicial review, a determination that the director defendants are exculpated from paying monetary damages can be made only *after the basis* for their liability has been decided." *Id.* at 94. In such a circumstance, defendant directors can avoid personal liability for paying monetary damages only if they establish that their failure to withstand an entire fairness analysis was exclusively attributable to a violation of the duty of care. *Id.* at 98.

⁵⁵⁹ The Texas analogue to DGCL § 102(b)(7) is TBOC § 7.001, which provides in relevant part:

(b) The certificate of formation or similar instrument of an organization to which this section applies [generally, corporations] may provide that a governing person of the organization is not liable, or is liable only to the extent provided by the certificate of formation or similar instrument, to the organization or its owners or members for monetary damages for an act or omission by the person in the person's capacity as a governing person.

(c) Subsection (b) does not authorize the elimination or limitation of the liability of a governing person to the extent the person is found liable under applicable law for:

- (1) a breach of the person's duty of loyalty, if any, to the organization or its owners or members;
- (2) an act or omission not in good faith that:

(b) Renunciation of Corporate Opportunities. Both Texas and Delaware law permit a corporation to renounce any interest in business opportunities presented to the corporation or one or more of its officers, directors or shareholders in its certificate of formation or by action of its board of directors.⁵⁶⁰ While this allows a corporation to specifically forgo individual corporate opportunities or classes of opportunities, the type of judicial scrutiny applied to the decision to make any such renunciation of corporate opportunities will generally be governed by a traditional common law fiduciary duty analysis.⁵⁶¹

(c) Interested Director Transactions. Both Texas and Delaware have embraced the principle that a transaction or contract between a director or officer and the corporation served is presumed to be valid and will not be void or voidable solely by reason of the interest of the director or officer as long as certain conditions are met.

DGCL § 144 provides that a contract between a director or officer and the corporation served will not be voidable due to the interest of the director or officer if (i) the transaction or contract is approved in good faith by a majority of the disinterested directors after the material facts as to the relationship or interest and as to the transaction or contract are disclosed or known to the directors, (ii) the transaction or contract is approved in good faith by shareholders after the material facts as to the relationship or interest and as to the transaction or contract is disclosed or known to the shareholders, or (iii) the transaction or contract is fair to the corporation as of the time it is authorized, approved, or ratified by the directors or shareholders of the corporation.⁵⁶²

(A) constitutes a breach of duty of the person to the organization; or

(B) involves intentional misconduct or a knowing violation of law;

(3) a transaction from which the person received an improper benefit, regardless of whether the benefit resulted from an action taken within the scope of the person's duties; or

(4) an act or omission for which the liability of a governing person is expressly provided by an applicable statute.

TMCLA art. 1302-7.06 provides substantially the same.

⁵⁶⁰ TBCA art. 2.02(20), TBOC § 2.101(21); DGCL § 122(17).

⁵⁶¹ R. Franklin Balotti & Jesse A. Finkelstein, *THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS* § 2.1 (2d ed. 1997); *see generally id.* at § 4.36.

⁵⁶² DGCL § 144 provides as follows:

(a) No contract or transaction between a corporation and 1 or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which 1 or more of its directors or officers, are directors or officers, or have a financial interest, shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee which authorizes the contract or transaction, or solely because any such director's or officer's votes are counted for such purpose, if:

(1) The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or

(2) The material facts as to the director's or officer's relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote

In *Fliegler v. Lawrence*, however, the Delaware Supreme Court held that where the votes of directors, qua stockholders, were necessary to garner stockholder approval of a transaction in which the directors were interested, the taint of director self-interest was not removed, and the transaction or contract may still be set aside and liability imposed on a director if the transaction is not fair to the corporation.⁵⁶³ The question remains, however, whether approval by a majority

thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders; or

(3) the contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee or the shareholders.

(b) Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board of directors or of a committee which authorizes the contract or transaction.

⁵⁶³

Fliegler v. Lawrence, 361 A.2d 218, 222 (Del. 1976). In *Sutherland v. Sutherland*, C.A. No. 2399-VCL, 2009 Del. Ch. LEXIS 46, at *9 (Del. Ch. March 23, 2009), *clarified by* No. 2399-VCL, 2009 Del. Ch. LEXIS 52 (Del. Ch. Apr. 22, 2009), the Court of Chancery held that an exculpatory provision in a corporation's certificate of incorporation purporting to immunize interested transactions from entire fairness review would effectively eviscerate the duty of loyalty for corporate directors and would, therefore, be void as contrary to the laws of Delaware and against public policy. The provision at issue in *Sutherland* read in pertinent part:

Any director individually . . . may be a party to or may be pecuniarily or otherwise interested in any contract or transaction of the corporation, provided that the fact that he . . . is so interested shall be disclosed or shall have been known to the board of directors, or a majority thereof; and any director of the corporation, who is . . . so interested, may be counted in determining the existence of a quorum at any meeting of the board of directors of the corporation which shall authorize such contract or transaction, and may vote thereat to authorize any such contract or transaction, with like force and effect, as if he were not . . . so interested.

The Court construed the provision at issue to simply mean that interested directors may be counted toward a quorum; since the provision did not sanitize disloyal transactions, it was valid. The Court then proceeded to explain that if the provision would transmogrify an interested director into a disinterested one for the purposes of approving a transaction, it would be void:

However, if, *arguendo*, the meaning of the provision is as the defendants suggest, interested directors would be treated as disinterested for the purposes of approving corporate transactions. Because approval by a majority of disinterested directors affords a transaction the presumptions of the business judgment rule, all interested transactions would be immunized from entire fairness analysis under this scheme. Thus, the only basis that would remain to attack a self-dealing transaction would be waste.

The question that remains then is whether such a far-reaching provision would be enforceable under Delaware law. It would not. If the meaning of the above provision were as the defendants suggest, it would effectively eviscerate the duty of loyalty for corporate directors as it is generally understood under Delaware law. While such a provision is permissible under the Delaware Limited Liability Company Act and the Delaware Revised Uniform Limited Partnership Act, where freedom of contract is the guiding and overriding principle, it is expressly forbidden by the DGCL. Section 102(b)(7) of the DGCL provides that a corporate charter may contain a provision eliminating or limiting personal liability of a director for money damages in a suit for breach of fiduciary duty, so long as such provision does not affect director liability for “any breach of the director’s duty of loyalty to the corporation or its stockholders. . . .”

The effect of the provision at issue would be to do exactly what is forbidden. It would render any breach of the duty of loyalty relating to a self-dealing transaction beyond the reach of a court to remedy by way of damages. The exculpatory charter provision, if construed in the manner suggested by the defendants, would therefore be void as “contrary to the laws of

of disinterested stockholders will, pursuant to DGCL § 144(a)(2), cure any invalidity of director actions and, by virtue of the stockholder ratification, eliminate any director liability for losses from such actions.⁵⁶⁴

In 1985, Texas followed Delaware’s lead in the area of interested director transactions and adopted TBCA article 2.35-1,⁵⁶⁵ the predecessor to TBOC § 21.418. In general, these Tex. Corp. Stats. provide that a transaction between a corporation and one or more of its directors or officers will not be voidable solely by reason of that relationship if the transaction is approved by shareholders or disinterested directors after disclosure of the interest, or if the transaction is otherwise fair.⁵⁶⁶ Because TBCA art. 2.35-1, as initially enacted, was essentially identical to DGCL § 144, some uncertainty on the scope of TBCA art. 2.35-1 arose because of *Fliegler’s* interpretation of DGCL § 144. This imposition of a fairness gloss on the Texas statute rendered the effect of the safe harbor provisions in TBCA article 2.35-1 uncertain.

In 1997, TBCA article 2.35-1 was amended to address the ambiguity created by *Fliegler* and to clarify that contracts and transactions between a corporation and its directors and officers or in which a director or officer has a financial interest are valid notwithstanding that interest as long as any one of the following are met: (i) the disinterested directors of the corporation approve the transaction after disclosure of the interest, (ii) the shareholders of the corporation approve the transaction after disclosure of the interest or (iii) the transaction is fair.⁵⁶⁷ TBOC § 21.418 mirrors these clarifications. Under the Tex. Corp. Stats., if any one of these conditions

this State” and against public policy. As such, it could not form the basis for a dismissal of claims of self-dealing.

Thus, the charter provision, under either interpretation, provides no protection for the defendants beyond that afforded by Sections 144 of the DGCL. Because none of the safe-harbor provisions of Section 144(a)(1) or (a)(2) apply, the challenged interested transactions are not insulated on grounds of unfairness.

⁵⁶⁴ See *Michelson v. Duncan*, 407 A.2d 211, 219 (Del. 1979). In *Gantler v. Stephens*, 965 A.2d 695, 712 (Del. 2009), the Delaware Supreme Court found that stockholder approval of a going private stock reclassification proposal did not effectively ratify or cleanse the transaction for two reasons:

First, because a shareholder vote was required to amend the certificate of incorporation, that approving vote could not also operate to “ratify” the challenged conduct of the interested directors. Second, the adjudicated cognizable claim that the Reclassification Proxy contained a material misrepresentation, eliminates an essential predicate for applying the doctrine, namely, that the shareholder vote was fully informed.

* * *

[T]he scope of the shareholder ratification doctrine must be limited to its so-called “classic” form; that is, to circumstances where a fully informed shareholder vote approves director action that does not legally require shareholder approval in order to become legally effective. Moreover, the only director action or conduct that can be ratified is that which the shareholders are specifically asked to approve. With one exception, the “cleansing” effect of such a ratifying shareholder vote is to subject the challenged director action to business judgment review, as opposed to “extinguishing” the claim altogether (i.e., obviating all judicial review of the challenged action).

⁵⁶⁵ TBOC § 21.418; TBCA art. 2.35-1.

⁵⁶⁶ TBOC § 21.418; TBCA art. 2.35-1; see *Landon v. S & H Marketing Group, Inc.*, 82 S.W.3d 666, 671 (Tex. App.—Eastland 2002, no pet.).

⁵⁶⁷ TBCA art. 2.35-1.

is met, the contract will be considered valid notwithstanding the fact that the director or officer has an interest in the transaction.⁵⁶⁸ These provisions rely heavily on the statutory definitions of “*disinterested*” contained in TBCA art. 1.02 and TBOC § 1.003. Under these definitions, a director will be considered “*disinterested*” if the director is not a party to the contract or transaction or does not otherwise have a material financial interest in the outcome of the contract.⁵⁶⁹

TBCA Article 2.35-1 also changed the general approach of the statute from a mere presumption that a contract is not voidable by reason of the existence of an affiliated relationship if certain conditions are met to an absolute safe harbor that provides that an otherwise valid contract will be valid if the specified conditions are met, a change retained by TBOC § 21.418 which was amended in the 2011 Texas Legislature Session.⁵⁷⁰ Although the difference between

⁵⁶⁸ *Id.* art. 2.35-1(A); TBOC § 21.418(b).

⁵⁶⁹ TBCA art. 2.35-1(A); TBOC § 21.418(b).

⁵⁷⁰ TBOC § 21.418 (Contracts or Transactions Involving Interested Directors and Officers) was restructured in the 2011 Texas Legislature Session by S.B. 748 § 28 to make more clear its intent. TBOC § 21.418(a) was amended to clarify that it also applies to affiliates or associates of directors or officers that have the conflicting relationship or interest. TBOC § 21.418(b) was further amended to clarify that the contract or transaction is not void or voidable, and is valid and enforceable, notwithstanding the conflicting relationship or interest if the requirements of the Section are satisfied. Provisions formerly located in TBOC § 21.418(b) permitting the execution of a consent of directors, or the presence, participation or voting in the meeting of the board of directors, by the director or officer having the conflicting relationship or interest were moved to a new TBOC § 21.418(d). Finally, a new TBOC § 21.418(e) was added specifying that neither the corporation nor any of its shareholders have any cause of action against any of the conflicted officers or directors for breach of duty in respect of the contract or transaction because of such relationship or interest or the taking of any actions described by TBOC § 21.418(d). S.B. 748 § 28 reads as follows:

SECTION 28. Section 21.418, Business Organizations Code, is amended by amending Subsections (a) and (b) and adding Subsections (d) and (e) to read as follows:

(a) This section applies [only] to a contract or transaction between a corporation and:

(1) one or more [of the corporation’s] directors or officers, or one or more affiliates or associates of one or more directors or officers, of the corporation; or

(2) an entity or other organization in which one or more [of the corporation’s] directors or officers, or one or more affiliates or associates of one or more directors or officers, of the corporation;

(A) is a managerial official; or

(B) has a financial interest.

(b) An otherwise valid and enforceable contract or transaction described by Subsection (a) is valid and enforceable, and is not void or voidable, notwithstanding any relationship or interest described by Subsection (a), if any one of the following conditions is satisfied [~~notwithstanding that the director or officer having the relationship or interest described by Subsection (a) is present at or participates in the meeting of the board of directors, or of a committee of the board that authorizes the contract or transaction, or votes or signs, in the person’s capacity as a director or committee member, a unanimous written consent of directors or committee members to authorize the contract or transaction, if~~]:

(1) the material facts as to the relationship or interest described by Subsection (a) and as to the contract or transaction are disclosed to or known by:

(A) the corporation’s board of directors or a committee of the board of directors, and the board of directors or committee in good faith authorizes the contract or transaction by

the Texas and Delaware constructions is subtle, the distinction is significant and provides more certainty as transactions are structured. However, these Tex. Corp. Stats. do not eliminate a director's or officer's fiduciary duty to the corporation.

2.6.9. Duties When Company on Penumbra of Insolvency.

(a) Insolvency Can Change Relationships. While creditors' power over the corporate governance of a solvent company is limited to the rights given to them by their contracts, their influence expands as the company approaches insolvency. As a troubled company approaches insolvency, its creditors may organize into ad hoc committees to negotiate with, and perhaps attempt to dictate to, the company about its future and its restructuring efforts.⁵⁷¹ They may become aggressive in asserting that the company's resources should be directed toward getting them paid rather than taking business risks that could, if successful, create value for the shareholders.⁵⁷² Once a troubled company enters formal proceedings under the Bankruptcy Code, the corporation becomes subject to the powers of a Bankruptcy Court which must approve all actions outside of the ordinary course of business, although (depending on the nature of the proceedings)⁵⁷³ the corporation may continue to be governed by its Board or a trustee may be

the approval of the majority of the disinterested directors or committee members, regardless of whether the disinterested directors or committee members constitute a quorum; or

(B) the shareholders entitled to vote on the authorization of the contract or transaction, and the contract or transaction is specifically approved in good faith by a vote of the shareholders; or

(2) the contract or transaction is fair to the corporation when the contract or transaction is authorized, approved, or ratified by the board of directors, a committee of the board of directors, or the shareholders.

(d) A person who has the relationship or interest described by Subsection (a) may:

(1) be present at or participate in and, if the person is a director or committee member, may vote at a meeting of the board of directors or of a committee of the board that authorizes the contract or transaction; or

(2) sign, in the person's capacity as a director or committee member, a unanimous written consent of the directors or committee members to authorize the contract or transaction.

(e) If at least one of the conditions of Subsection (b) is satisfied, neither the corporation nor any of the corporation's shareholders will have a cause of action against any of the persons described by Subsection (a) for breach of duty with respect to the making, authorization, or performance of the contract or transaction because the person had the relationship or interest described by Subsection (a) or took any of the actions authorized by Subsection (d).

Cf. Val D. Ricks, Texas' So-Called "Interested Director" Statute, 50 S. TEX. L. REV. 129 (Winter 2008).

⁵⁷¹ D.J. (Jan) Baker, John Wm. (Jack) Butler, Jr., & Mark A. McDermott, *Corporate Governance of Troubled Companies and the Role of Restructuring Counsel*, 63 Bus. Law. 855 (May 2008).

⁵⁷² *Id.*

⁵⁷³ The directors in office prior to the Chapter 11 filing continue in office until replaced under the entity's governing documents, applicable state law or section 1104 of the Bankruptcy Code. Section 1104 of the Bankruptcy Code authorizes the court to order the appointment of a trustee for cause or if such appointment is in the best interests of creditors, any equity holders and other interests of the estate, or if grounds exist for conversion to Chapter 7 or dismissal, but the court determines that a trustee is a better alternative. In a Chapter 7 case, a trustee is appointed to liquidate the corporation.

appointed to administer its assets for the benefit of its creditors.⁵⁷⁴ In addition, a committee of unsecured creditors may be appointed. The committee has standing to appear and be heard on any matter in the bankruptcy case, including any attempt by the debtor to obtain approval from the Bankruptcy Court to take actions outside of the debtor's ordinary business.⁵⁷⁵ Committees on occasion seek to impose their will by suing, or threatening to sue, directors for breaches of fiduciary duty if they believe that the company did not act appropriately.⁵⁷⁶ In the troubled company context, directors often face vocal and conflicting claims to their attention and allegiance from multiple constituencies as they address issues that affect the groups differently.

Directors owe fiduciary duties to the corporation and its owners.⁵⁷⁷ When the corporation is solvent, the directors owe fiduciary duties to the corporation and to the shareholders of the corporation.⁵⁷⁸ The creditor's relationship to the corporation is contractual in nature. A solvent corporation's directors do not owe any fiduciary duties to the corporation's creditors, whose rights in relation to the corporation are those that they have bargained for and memorialized in their contracts.⁵⁷⁹

In Texas a corporation's directors continue to owe shareholders, not creditors, fiduciary duties "so long as [the corporation] continues to be a going concern, conducting its business in the ordinary way, without some positive act of insolvency, such as the filing of a bill to administer its assets, or the making of a general assignment."⁵⁸⁰ When the corporation is both insolvent and has ceased doing business, the corporation's creditors become its owners and the

⁵⁷⁴ Cf. *Torch Liquidating Trust v. Stockstill*, 561 F.3d 377, 380 (5th Cir. 2009), and *Thornton v. Bernard Tech., Inc.*, C.A. No. 962-VCN, 2009 WL 426179, at *1 (Del. Ch. Feb. 20, 2009).

⁵⁷⁵ Cf. *Torch*, 561 F.3d at 380; *Bernard Tech*, 2009 WL 426179 at *1.

⁵⁷⁶ Myron M. Sheinfeld & Judy Harris Pippitt, *Fiduciary Duties of Directors of a Corporation in the Vicinity of Insolvency and After Initiation of a Bankruptcy Case*, 60 Bus. Law. 79 (Nov. 2004).

⁵⁷⁷ Delaware Vice Chancellor Leo E. Strine, *Comments at the 24th Annual Conference on Securities Regulation and Business Law Problems: Sponsored by University of Texas School of Law*, et al. (February 22, 2002).

⁵⁷⁸ *Hoggett v. Brown*, 971 S.W. 2d 472, 488 (Tex. App.—Houston [14th Dist.] 1997, pet. denied) ("A director's fiduciary duty runs only to the corporation, not to individual shareholders or even to a majority of the shareholders" [citing *Gearhart Indus., Inc. v. Smith Int'l, Inc.*, 741 F.2d 707, 721 (5th Cir. 1984)]. Similarly, a co-shareholder in a closely held corporation does not as a matter of law owe a fiduciary duty to his co-shareholder . . . whether such duty exists depends on the circumstances [as] if a confidential relationship exists [which] is ordinarily a question of fact for the jury . . .); *North American Catholic Educational Programming Foundation Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007) ("The directors of Delaware corporations have 'the legal responsibility to manage the business of a corporation for the benefit of its shareholders owners'" (quoting *Malone v. Brincat*, 722 A.2d 5, 10 (1998)); see Norman Veasey & Christine T. Di Guglielmo, *How Many Masters Can a Director Serve? A Look at the Tensions Facing Constituency Directors*, 63 Bus. Law. 761 (May 2008).

⁵⁷⁹ See *Fagan v. La Gloria Oil & Gas Co.*, 494 S.W.2d 624, 628 (Tex. Civ. App.—Houston [14th Dist.] 1973, no writ) ("[O]fficers and directors of a corporation owe to it duties of care and loyalty. . . . Such duties, however, are owed to the corporation and not to creditors of the corporation.").

⁵⁸⁰ *Conway v. Bonner*, 100 F.2d 786, 787 (5th Cir. 1939); *Floyd v. Hefner*, C.A. No. H-03-5693, 2006 WL 2844245, at *10 (S.D. Tex. Sept. 29, 2006) (quoting *Conway v. Bonner*); see *Askanase v. Fatjo*, No. H-91-3140, 1993 WL 208440, at *4 (S.D. Tex. April 22, 1993), *aff'd* 130 F.3d 657 (5th Cir. 1997); but see *Carrieri v. Jobs.com*, 393 F.3d 508, 534 n.24 (5th Cir. 2004) ("Officers and directors that are aware that the corporation is insolvent, or within the 'zone of insolvency' . . . have expanded fiduciary duties to include the creditors of the corporation.").

directors owe fiduciary duties to the creditors as the owners of the business in the sense they have a duty to administer the corporation's remaining assets as a trust fund for the benefit of all of the creditors.⁵⁸¹ The duties of directors of an insolvent corporation to its creditors, however, do not require that the directors must abandon their efforts to direct the affairs of the corporation in a manner intended to benefit the corporation and its shareholders or that they lose the protections of the business judgment rule.⁵⁸² However, owing a duty of loyalty means that "a self-interested director cannot orchestrate the sale of a corporation's assets for his benefit below the price that diligent marketing efforts would have obtained."⁵⁸³ The trust fund doctrine in Texas requires the directors and officers of an insolvent corporation to deal fairly with its creditors without preferring one creditor over another or themselves to the injury of other creditors.⁵⁸⁴ Even where they are not direct beneficiaries of fiduciary duties, the creditors of an insolvent corporation may benefit from the fiduciary duties which continue to be owed to the corporation.⁵⁸⁵

⁵⁸¹ *Floyd*, 2006 WL 2844245 at *10; *Askanase*, 1993 WL 208440 at *4; see also *Hixson v. Pride of Tex. Distrib. Co.*, 683 S.W.2d 173, 176 (Tex. App.—Fort Worth 1985, no writ); *State v. Nevitt*, 595 S.W.2d 140, 143 (Tex. App.—Dallas 1980, writ ref'd n.r.e.); and *Fagan v. La Gloria Oil & Gas. Co.*, 494 S.W.2d 624, 628 (Tex. App.—Houston [14th Dist.] 1973, no writ).

⁵⁸² *Floyd*, 2006 WL 2844245 at *24 (concluding that "Texas law does not impose fiduciary duties in favor of creditors on the directors of an insolvent, but still operating, corporation, [but] it does require those directors to act as fiduciaries of the corporation itself" and that *Gearhart Industries, Inc. v. Smith International, Inc.*, 741 F.2d 707, 719 (5th Cir. 1984), remains the controlling statement of Texas director fiduciary duty law); see Glenn D. West & Emmanuel U. Obi, *Corporations*, 60 SMU L. REV. 885, 910-11 (2007). *Floyd v. Hefner* was not followed by *In Re: Vartec Telecom, Inc.*, in which the Bankruptcy Court wrote: "[A] cause of action based on a company's directors' and officers' fiduciary duty to creditors when the company is in the 'vicinity' or 'zone' of insolvency is recognized in both states [Texas and Delaware]." Case No. 04-81694-HDH-7, 2007 WL 2872283, at *2 (Bankr. N.D. Tex. Sept. 24, 2007).

⁵⁸³ *Floyd*, 2006 WL 2844245 at *14; cf. *In re Performance Nutrition, Inc.*, 239 B.R. 93, 99 (Bankr. N.D. Tex. 1999); *In re General Homes Corp.*, 199 B.R. 148, 150 (S.D. Tex. 1996).

⁵⁸⁴ *Plas-Tex v. Jones*, No. 03-99-00289-CV, 2000 WL 632677 at *4 (Tex. App.—Austin 2002, no pet.) ("As a general rule, corporate officers and directors owe fiduciary duties only to the corporation and not to the corporation's creditors, unless there has been prejudice to the creditors. . . . However, when a corporation is insolvent, a fiduciary relationship arises between the officers and directors of the corporation and its creditors, and creditors may challenge a breach of the duty. . . . Officers and directors of an insolvent corporation have a fiduciary duty to deal fairly with the corporation's creditors, and that duty includes preserving the value of the corporate assets to pay corporate debts without preferring one creditor over another or preferring themselves to the injury of other creditors. . . . However, a creditor may pursue corporate assets and hold directors liable only for 'that portion of the assets that would have been available to satisfy his debt if they had been distributed pro rata to all creditors.'"); *Geyer v. Ingersoll Pub. Co.*, 621 A.2d 784, 787 (Del. Ch. 1992) ("[T]he general rule is that directors do not owe creditors duties beyond the relevant contractual terms absent 'special circumstances' . . . e.g., fraud, insolvency or a violation of a statute. . . ." [citation omitted]. Furthermore, [no one] seriously disputes that when the insolvency does arise, it creates fiduciary duties for directors for the benefit of creditors. Therefore, the issue . . . is when do directors' fiduciary duties to creditors arise via insolvency."); see Allen M. Terrell, Jr. & Andrea K. Short, *Directors Duties in Insolvency: Lessons From Allied Riser*, 14 Bankr. L. Rep. (BNA) 293 (March 14, 2002).

⁵⁸⁵ *Floyd*, 2006 WL 2844245 at *24.

In Delaware, the corporation need not have ceased doing business for that trust fund to arise and the directors to owe duties to creditors.⁵⁸⁶ However, the Delaware formulation of the trust fund doctrine would not afford relief to creditors if the self-dealing was fair:

[C]reditors need protection even if an insolvent corporation is not liquidating, because the fact of insolvency shifts the risk of loss from the stockholders to the creditors. While stockholders no longer risk further loss, creditors become at risk when decisions of the directors affect the corporation's ability to repay debt. This new fiduciary relationship is certainly one of loyalty, trust and confidence, but it does not involve holding the insolvent corporation's assets in trust for distribution to creditors or holding directors strictly liable for actions that deplete corporate assets.⁵⁸⁷

The trust fund doctrine does not preclude the directors from allowing the corporation to take on economic risk for the benefit of the corporation's equity owners.⁵⁸⁸ Rather, the shifting merely exonerates the directors who choose to maintain the corporation's long term viability by considering the interests of creditors.⁵⁸⁹

⁵⁸⁶ *Askanase*, 1993 WL 208440; *Geyer v. Ingersoll Pub. Co.*, 621 A. 2d 784, 787 (Del. Ch. 1992) (“[T]he general rule is that directors do not owe creditors duties beyond the relevant contractual terms absent ‘special circumstances’ . . . e.g., fraud, insolvency or a violation of a statute. . . .” [citation omitted]. Furthermore, [no one] seriously disputes that when the insolvency does arise, it creates fiduciary duties for directors for the benefit of creditors. Therefore, the issue . . . is when do directors’ fiduciary duties to creditors arise via insolvency.”); see Allen M. Terrell, Jr. & Andrea K. Short, *Directors Duties in Insolvency: Lessons From Allied Riser*, 14 Bankr. L. Rep. (BNA) 293 (March 14, 2002).

⁵⁸⁷ *Decker v. Mitchell (In re JTS Corp.)*, 305 B.R. 529, 539 (Bankr. N.D. Cal. 2003).

⁵⁸⁸ *North American Catholic Educational Programming Foundation Inc. v. Gheewalla*, 930 A2d 92, 100 (Del. 2007); *Floyd*, 2006 WL 2844245; see *U.S. Bank v. Stanley*, 297 S.W.3d 815, 820 (Tex. App.—Houston [14th Dist.] 2009, no pet.) (“Delaware law recognizes that the directors’ obligations to a corporation and its shareholders may at times put them at odds with the creditors: It is the obligation of directors to attempt, within the law, to maximize the long-run interests of the corporation’s stockholders; that they may sometimes do so at the expense of others . . . does not for that reason constitute a breach of duty. It seems likely that corporate restructurings designed to maximize shareholder values may in some instances have the effect of requiring bondholders to bear greater risk of loss and thus in effect transfer economic value from bondholders to stockholders. * * * Likewise, the representation in a management presentation that the appellees authorized expenditures totaling \$225 million with “no positive results” and the evidence of the reduction in TransTexas’ assets between the two bankruptcies does not raise a genuine issue as to damages. Companies often spend money that does not achieve positive results, and they may become insolvent as a result. The mere assertion that TransTexas, a company engaged in oil and gas exploration efforts — an enterprise that inherently involves certain risks — spent too much money and achieved too little results — does not equate to a damages theory or model.”); Rutheford B. Campbell, Jr. & Christopher W. Frost, *Managers’ Fiduciary Duties in Financially Distressed Corporations: Chaos in Delaware (and Elsewhere)*, 32 J. CORP. L. 492 (Spring 2007).

⁵⁸⁹ Rutheford B. Campbell, Jr. & Christopher W. Frost, *Managers’ Fiduciary Duties in Financially Distressed Corporations: Chaos in Delaware (and Elsewhere)*, 32 J. CORP. L. 492 (Spring 2007); see *Equity-Linked Investors, L.P. v. Adams*, 705 A.2d 1040, 1042 n.2 (Del. Ch. 1997) (“[W]here foreseeable financial effects of a board decision may importantly fall upon creditors as well as holders of common stock, as where corporation is in the vicinity of insolvency, an independent board may consider impacts upon all corporate constituencies in exercising its good faith business judgment for benefit of the ‘corporation.’”).

(b) When is a Corporation Insolvent or in the Vicinity of Insolvency. There are degrees of insolvency (e.g., a corporation may be unable to pay its debts as they come due because of troubles with its lenders or its liabilities may exceed the book value of its assets, but the intrinsic value of the entity may significantly exceed its debts).⁵⁹⁰ Sometimes it is unclear whether the corporation is insolvent. In circumstances where the corporation is on the penumbra of insolvency, the directors may owe fiduciary duties to the “whole enterprise.”⁵⁹¹ Owing

⁵⁹⁰ See Rutheford B. Campbell, Jr. & Christopher W. Frost, *Managers’ Fiduciary Duties in Financially Distressed Corporations: Chaos in Delaware (and Elsewhere)*, 32 J. Corp. L. 491 (2007).

⁵⁹¹ *Geyer v. Ingersoll Pub. Co.*, 621 A. 2d 784, 789 (Del. Ch. 1992) (“The existence of the fiduciary duties at the moment of insolvency may cause directors to choose a course of action that best serves the entire corporate enterprise rather than any single group interested in the corporation at a point in time when the shareholders’ wishes should not be the directors only concern.”). See *Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc’ns Corp.*, which expressed the following in *dicta*:

The possibility of insolvency can do curious things to incentives, exposing creditors to risks of opportunistic behavior and creating complexities for directors. Consider, for example, a solvent corporation having a single asset, a judgment for \$51 million against a solvent debtor. The judgment is on appeal and thus subject to modification or reversal. Assume that the only liabilities of the company are to bondholders in the amount of \$12 million. Assume that the array of probable outcomes of the appeal is as follows:

	Expected Value
25% chance of affirmance (\$51mm)	\$12.75
70% chance of modification (\$4 mm)	2.8
5% chance of reversal (\$0)	0
Expected value of Judgment on Appeal	\$15.55

Thus, the best evaluation is that the current value of the equity is \$3.55 million. (\$15.55 million expected value of judgment on appeal \$12 million liability to bondholders). Now assume an offer to settle at \$12.5 million (also consider one at \$17.5 million). By what standard do the directors of the company evaluate the fairness of these offers? The creditors of this solvent company would be in favor of accepting either a \$12.5 million offer or a \$17.5 million offer. In either event they will avoid the 75% risk of insolvency and default. The stockholders, however, will plainly be opposed to acceptance of a \$12.5 million settlement (under which they get practically nothing). More importantly, they very well may be opposed to acceptance of the \$17.5 million offer under which the residual value of the corporation would increase from \$3.5 to \$5.5 million. This is so because the litigation alternative, with its 25% probability of a \$39 million outcome to them (\$51 million - \$12 million \$39 million) has an expected value to the residual risk bearer of \$9.75 million (\$39 million x 25% chance of affirmance), substantially greater than the \$5.5 million available to them in the settlement. While in fact the stockholders’ preference would reflect their appetite for risk, it is possible (and with diversified shareholders likely) that shareholders would prefer rejection of both settlement offers.

But if we consider the community of interests that the corporation represents it seems apparent that one should in this hypothetical accept the best settlement offer available providing it is greater than \$15.55 million, and one below that amount should be rejected. But that result will not be reached by a director who thinks he owes duties directly to shareholders only. It will be reached by directors who are capable of conceiving of the corporation as a legal and economic entity. Such directors will recognize that in managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act.

C.A. No. 12150, 1991 Del. Ch. LEXIS 215 at n.55 (Del. Ch. 1991).

fiduciary duties to the “whole enterprise” puts the directors in the uncomfortable position of owing duties to the corporation which may have multiple constituencies having conflicting interests that may claim the right to enforce on behalf of the corporation.⁵⁹²

In Delaware it is the fact of insolvency, rather than the commencement of statutory bankruptcy or other insolvency proceedings, that causes the shift in the focus of director duties.⁵⁹³ Delaware courts define insolvency as occurring when the corporation “is unable to pay its debts as they fall due in the usual course of business . . . or it has liabilities in excess of a reasonable market value of assets held.”⁵⁹⁴

Under the “balance sheet” test used for bankruptcy law purposes, insolvency is defined as when an entity’s debts exceed the entity’s property at fair valuation,⁵⁹⁵ and the value at which the assets carried for financial accounting or tax purposes is irrelevant.

Fair value of assets is the amount that would be realized from the sale of assets within a reasonable period of time.⁵⁹⁶ Fair valuation is not liquidation or book value, but is the value of the assets considering the age and liquidity of the assets, as well as the conditions of the trade.⁵⁹⁷ For liabilities, the fair value assumes that the debts are to be paid according to the present terms of the obligations.

Directors’ duties, however, do not shift before the moment of insolvency. The Delaware Supreme Court has explained: “When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners.”⁵⁹⁸ In cases where the corporation has been found to be in the vicinity of insolvency, the entity was in dire financial straits with a bankruptcy petition likely in the minds of the directors.⁵⁹⁹

⁵⁹² See *Odyssey Partners, L.P. v. Fleming Cos., Inc.*, 735 A.2d 386, 420 (Del. Ch. 1999).

⁵⁹³ *Geyer*, 621 A. 2d at 789.

⁵⁹⁴ *Id.*

⁵⁹⁵ 11 U.S.C. § 101(32) (2012). A “balance sheet” test is also used under the fraudulent transfer statutes of Delaware and Texas. See DEL. CODE ANN. tit. 6, § 1302 and TEX. BUS. & COM. CODE § 24.003. For general corporate purposes, TBOC § 1.002(39) defines insolvency as the “inability of a person to pay the person’s debts as they become due in the usual course of business or affairs.” TBCA art. 1.02(A)(16) provides substantially the same. For transactions covered by the U.C.C., TEX. BUS. & COM. CODE 1.201(23) (2001) defines an entity as “insolvent” who either has ceased to pay its debts in the ordinary course of business or cannot pay its debts as they become due or is insolvent within the meaning of the federal bankruptcy law.

⁵⁹⁶ Cf. *Production Resources Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 799 (Del. Ch. 2004); *Angelo, Gordon & Co., L.P. v. Allied Riser Commc’ns Corp.*, 805 A.2d 221, 223 (Del. Ch. 2002).

⁵⁹⁷ *In re United Finance Corporation*, 104 F.2d 593, 598 (7th Cir. 1939).

⁵⁹⁸ *North American Catholic Educational Programming Foundation Inc. v. Gheewalla*, 930 A2d 92, 101 (Del. 2007); but cf. *Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc’ns Corp.*, C.A. No. 12150 Mem. Op., 1991 Del. Ch. LEXIS 215, at *2 (Del. Ch. 1991).

⁵⁹⁹ In *Credit Lyonnais*, a bankruptcy petition had recently been dismissed, but the corporation continued to labor “in the shadow of that prospect.” 1991 Del. Ch. LEXIS 215, at *2; see also *Equity-Linked Investors*

(c) Director Liabilities to Creditors. The issue of creditor rights to sue directors for breach of fiduciary duty was resolved for Delaware corporations in *North American Catholic Educational Programming Foundation Inc. v. Gheewalla* in 2007.⁶⁰⁰ In *Gheewalla*, the Delaware Supreme Court held “that the creditors of a Delaware corporation that is either insolvent or in the zone of insolvency have no right, as a matter of law, to assert direct claims for breach of fiduciary duty against the corporation’s directors,” but the creditors of an insolvent corporation may bring a derivative action on behalf of the corporation against its directors.⁶⁰¹ The Delaware Supreme Court elaborated as follows:

It is well established that the directors owe their fiduciary obligations to the corporation and its shareholders. While shareholders rely on directors acting as fiduciaries to protect their interests, creditors are afforded protection through contractual agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, bankruptcy law, general commercial law and other sources of creditor rights. Delaware courts have traditionally been reluctant to expand existing fiduciary duties. Accordingly, “the general rule is that directors do not owe creditors duties beyond the relevant contractual terms.”

* * *

In this case, the need for providing directors with definitive guidance compels us to hold that no direct claim for breach of fiduciary duties may be asserted by the creditors of a solvent corporation that is operating in the zone of insolvency. When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners. Therefore, we hold the Court of Chancery properly concluded that Count II of the NACEPF Complaint fails to state a claim, as a matter of Delaware law, to the extent that it attempts to assert a direct claim for breach of fiduciary duty to a creditor while Clearwire was operating in the zone of insolvency.

* * *

It is well settled that directors owe fiduciary duties to the corporation. When a corporation is *solvent*, those duties may be enforced by its shareholders, who have standing to bring *derivative* actions on behalf of the corporation because they are the ultimate beneficiaries of the corporation’s growth and

LP v. Adams, 705 A.2d 1040, 1041 (Del. Ch. 1997) (corporation found to be on “lip of insolvency” where a bankruptcy petition had been prepared and it had only cash sufficient to cover operations for one more week).

⁶⁰⁰ 930 A.2d 92, 94 (Del. 2007); *cf.* Sabin Willett, *Gheewalla and the Director’s Dilemma*, 64 BUS. LAW. 1087 (August 2009).

⁶⁰¹ *Id.* at 94; *see CML V, LLC v. Bax*, 6 A.3d 238, 239 (Del. Ch. 2010) (creditors of an insolvent LLC cannot sue derivatively).

increased value. When a corporation is *insolvent*, however, its creditors take the place of the shareholders as the residual beneficiaries of any increase in value.

Consequently, the creditors of an insolvent corporation have standing to maintain derivative claims against directors on behalf of the corporation for breaches of fiduciary duties. The corporation's insolvency "makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm's value." Therefore, equitable considerations give creditors standing to pursue derivative claims against the directors of an insolvent corporation. Individual creditors of an insolvent corporation have the same incentive to pursue valid derivative claims on its behalf that shareholders have when the corporation is solvent.

* * *

Recognizing that directors of an insolvent corporation owe direct fiduciary duties to creditors, would create uncertainty for directors who have a fiduciary duty to exercise their business judgment in the best interest of the insolvent corporation. To recognize a new right for creditors to bring direct fiduciary claims against those directors would create a conflict between those directors' duty to maximize the value of the insolvent corporation for the benefit of all those having an interest in it, and the newly recognized direct fiduciary duty to individual creditors. Directors of insolvent corporations must retain the freedom to engage in vigorous, good faith negotiations with individual creditors for the benefit of the corporation. Accordingly, we hold that individual *creditors* of an *insolvent* corporation have *no right to assert direct* claims for breach of fiduciary duty against corporate directors. Creditors may nonetheless protect their interest by bringing derivative claims on behalf of the insolvent corporation or any *other* direct nonfiduciary claim, as discussed earlier in this opinion, that may be available for individual creditors.⁶⁰²

The Fifth Circuit followed *Gheewalla* in *Torch Liquidating Trust v. Stockstill*⁶⁰³ in which a bankruptcy trustee brought a derivative action on behalf of the creditors and shareholders of a Delaware corporation against its officers and directors alleging breach of fiduciary duties by the officers and directors. The Fifth Circuit held that:

[T]he trustee ... may bring D&O claims that were part of debtor's estate on behalf of the Trust; it need not allege a derivative suit based on either shareholder or creditor derivative standing. Although plaintiff has standing, it fails to state a claim for which the court may grant relief. It argues that it is attempting to assert a breach of fiduciary duties owed to Torch but fails to allege necessary elements of such a claim—specifically, but not limited to, injury to Torch. As the district court recognized, when plaintiff amended its complaint, it failed to allege a claim on behalf of Torch and continued to maintain what appear to be impermissible

⁶⁰² *Id.* at 99-103.

⁶⁰³ 561 F.3d 377, 383 (5th Cir. 2009).

direct claims on behalf of creditors, now clothed in the unnecessary pleadings of a derivative action (ostensibly, but never expressly, on behalf of Torch). ***

The Trust, through its trustee Bridge Associates, attempts to allege—in the form of a shareholder and creditor derivative suit—that the Directors breached their fiduciary duties. This ill-conceived pleading posture distracts from Bridge Associates’s standing as trustee to bring a direct suit on the Trust’s behalf for Torch’s claims against the Directors.

Under Delaware law, a claim alleging the directors’ or officers’ breach of fiduciary duties owed to a corporation may be brought by the corporation or through a shareholder derivative suit when the corporation is solvent or a creditor derivative suit when the corporation is insolvent. See *Gheewalla*, 930 A.2d at 101–02. A derivative suit “enables a stockholder to bring suit on behalf of the corporation for harm done to the corporation.” *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031, 1036 (Del. 2004). “The derivative action developed in equity to enable shareholders to sue in the corporation’s name where those in control of the company refused to assert a claim belonging to it.” *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984), partially overruled on other grounds by *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000). “The nature of the action is two-fold. First, it is the equivalent of a suit by the shareholders to compel the corporation to sue. Second, it is a suit by the corporation, asserted by the shareholders on its behalf, against those liable to it.” *Aronson*, 473 A.2d at 811. Shareholders have standing to enforce claims on behalf of a solvent corporation through a derivative suit “because they are the ultimate beneficiaries of the corporation’s growth and increased value.” *Gheewalla*, 930 A.2d at 101. If a corporation becomes insolvent, however, its creditors become the appropriate parties to bring a derivative suit on behalf of the corporation where those in control of it refuse to assert a viable claim belonging to it because the creditors are the beneficiaries of any increase in value. See *id.* (“When a corporation is *insolvent*, however, its creditors take the place of the shareholders as the residual beneficiaries of any increase in value. . . . Consequently, the creditors of an insolvent corporation have standing to maintain derivative claims against directors on behalf of the corporation for breaches of fiduciary duties.”). Whether brought by shareholders or creditors, “a derivative suit is being brought on behalf of the corporation, [so] the recovery, if any, must go to the corporation.” *Tooley*, 845 A.2d at 1036.

Having reviewed Delaware’s law on derivative suits, we now turn to consider the impact of a chapter 11 filing and plan confirmation on the standing of various parties to bring a suit on behalf of the debtor corporation and its bankruptcy estate. The filing of a chapter 11 petition creates an estate comprised of all the debtor’s property, including “all legal or equitable interests of the debtor in property as of the commencement of the case.” *** By definition then, a cause of action for breach of fiduciary duty owed to the corporation that is property of the corporation at commencement of the chapter 11 case becomes property of the debtor’s estate, regardless of whether outside of bankruptcy the

case was more likely to be brought by the corporation directly or by a shareholder or creditor through a derivative suit. ***

A chapter 11 plan of reorganization or liquidation then settles the estate's causes of action or retains those causes of action for enforcement by the debtor, the trustee, or a representative of the estate appointed for the purpose of enforcing the retained claims. *** To achieve the plan's goals, the retained assets of the estate may be transferred to a liquidating trust. ***

In this case, [the trustee] has standing to bring a suit on behalf of the Trust for the amended complaint's allegations that the Directors breached the fiduciary duties that they owed to Torch. When Torch filed its chapter 11 petition, all claims owned by it, including claims against the Directors for breach of fiduciary duties, became part of the estate. In turn, the Plan, as confirmed by the bankruptcy court, transferred all of the debtor estate's remaining assets to the Trust. As part of that transfer, the Plan and the court's order expressly preserved and transferred all D&O claims. *** [T]herefore, [the trustee] has standing to bring D&O claims on behalf of the Trust for injuries to Torch.⁶⁰⁴

Gheewalla was followed in *Quadrant Structured Products Co. Ltd. v. Vertin*,⁶⁰⁵ in which the Delaware Chancery Court dismissed a claim that the Board of an insolvent Delaware corporation breached its fiduciary duties by pursuing a risky business strategy to benefit the corporation's sole stockholder at the expense of the corporation's senior creditors. Although the sole stockholder designated all but one member of the corporation's Board and the corporation's CEO held the remaining Board seat, the court found that the stockholder's Board designees were not conflicted in the decision to change the company's investment strategy from a risk-off to a risk-on strategy, a change which required the company to amend its operating guidelines and obtain approval from its rating agencies. According to the court, directors of insolvent corporations possess wide latitude to pursue value-maximizing strategies which may benefit all of the corporation's residual claimants, including its creditors, even if the strategy might ultimately benefit one class of residual claimants more than others. The court also recognized that the corporation's senior creditors bore the full risk of the risk-on strategy's failure.

The court, however, declined to dismiss claims that the Board breached its fiduciary duties to the corporation by authorizing direct and specific payments to the sole stockholder at the expense of the corporation's senior creditors. The court further held that these claims would be reviewed under the entire fairness standard of review.

In reviewing plaintiff's claims, the court reiterated that post-*Gheewalla*, directors of an insolvent corporation do not owe direct fiduciary obligations to the corporation's creditors. Rather, as the principal constituency injured by fiduciary breaches that diminish the firm's value, creditors of an insolvent corporation may pursue derivative claims for fiduciary breaches that

⁶⁰⁴ *Id.* at 384-88.

⁶⁰⁵ 102 A.3d 155 (Del. Ch. 2014). See Lisa R. Stark, *Chancery Court Reaffirms Delaware's Deferential Approach to Evaluating Fiduciary Claims Brought by Creditors of Distressed Corporations*, BUSINESS LAW TODAY (Nov. 2014).

deplete the value of the corporation's assets. While the court rejected plaintiff's allegations as direct claims for breach of fiduciary duty. However, given that the corporation was insolvent on a balance sheet basis, the court found that Quadrant's creditors possessed standing to assert derivative claims on its behalf.

Quadrant thus reaffirms that directors of insolvent corporations have considerable latitude to pursue value-maximizing strategies which are designed to benefit the corporate enterprise as a whole, absent evidence that some compelling personal interest tainted the decision-making process.

(d) Business Judgment Rule—DGCL § 102(b)(7) During Insolvency. The business judgment rule is applicable to actions of directors even while the corporation is insolvent or on the penumbra thereof in circumstances where it would otherwise have been applicable.⁶⁰⁶ Courts have found the business judgment rule inapplicable where the party challenging the decision can show that the director or officer failed to consider the best interests of the insolvent corporation or its creditors or breached the duty of loyalty.⁶⁰⁷

Where directors of an insolvent corporation are interested, their conduct will likewise be judged by the standards that would have otherwise been applicable.⁶⁰⁸ A director's stock ownership may call into question a director's independence where the creditors are the

⁶⁰⁶ *N. Am. Catholic Educ. Programming Foundation Inc. v. Gheewalla*, 930 A.2d 92, 99-103 (Del. 2007); *Prod. Resources Grp., L.L.C. v. NCT Grp., Inc.*, 863 A.2d 772, 774 (Del. Ch. 2004); *Angelo, Gordon & Co., L.P. v. Allied Riser Commc'ns Corp.*, 805 A.2d at 228; *Floyd v. Hefner*, C.A. No. H-03-5693, 2006 WL 2844245, at *1 (S.D. Tex. Sept. 29, 2006); *Fleet Nat. Bank v. Boyle*, C.A. No. 04CV1277LDD, 2005 WL 2455673, at *1 (E.D. Pa. 2005); *In re Hechinger Inv. Co. of Del.*, 327 B.R. 537, 541 (D. Del. 2005); *Grove v. Bedard*, 2004 WL 2677216 (D. Me. 2004); *Roselink Investors, L.L.C. v. Shenkman*, 386 F.Supp.2d 209, 213 (S.D.N.Y. 2004); *Official Committee of Bond Holders of Metricom, Inc. v. Derrickson*, 2004 WL 2151336 (N.D. Cal. 2004); *In re Verestar, Inc.*, 343 B.R. 444, 454 (Bankr. S.D.N.Y. 2006); *but see Weaver v. Kellog*, 216 B.R. 563, 568 (S.D. Tex. 1997); *Askana v. Fatjo*, No. H-91-3140, 1993 WL 208440, at *1 (S.D. Tex. April 22, 1993), *aff'd* 130 F.3d 657 (5th Cir. 1997); *Kahn v. Lynch Comm'ns Sys., Inc.*, 638 A.2d 1110, 1115 (Del. 1994).

⁶⁰⁷ *RSL Commc'ns PLC ex rel. Jervis v. Bildirici*, No. 04-CV-5217, 2006 WL 2689869, at *1 (S.D.N.Y. 2006) (directors who served on board of parent and subsidiary breached duty by failing to take into consideration interests of creditors of subsidiary); *In re Greater Southeast Cmty. Hospital Corp. I v. Tuft*, 353 B.R. 324, 332 (Bankr. D. Col. 2006) (business judgment rule inapplicable where (1) the defendants benefited from the incurrence of debt because they received personal benefits, including bonuses and repayment of loans, (2) the defendant authorized the incurrence of debt in order to generate work for an affiliated law firm, and (3) the defendant served as a director for the lender that made the allegedly wrongful loans); *In re Enivid, Inc.*, 345 B.R. 426, 433 (Bankr. D. Mass. 2006) (complaint held to state claims for breach of the duty of loyalty under Delaware law where it contained allegations that (i) the CEO's principal motivation in the performance of his duties was his desire to maintain his position and office as the Company's chief executive officer and committed to a business strategy that was not in the best interests of the corporation, and (ii) the other officers were dominated by or beholden to the CEO, even though there was no allegation that the defendants were interested in or personally benefited from the transactions at issue); *In re Dehon, Inc.*, 334 B.R. 55, 57 (Bank. D. Mass. 2005) (directors authorized the payment of dividends when they knew the corporation was insolvent or in the vicinity of insolvency); *Roth v. Mims*, 298 B.R. 272, 277 (N.D. Tex. 2003) (officer not disinterested in sale transaction because he had negotiated employment agreement with purchaser prior to consummation and failed to disclose negotiations with board).

⁶⁰⁸ *RSL Commc'ns*, 2006 WL 2689869, at *1; *Greater Southeast Cmty. Hospital*, 353 B.R. at 332; *In re Enivid*, 345 B.R. at 433; *In re Dehon*, 334 B.R. 55, 57; *Roth*, 298 B.R. 272, 277 (N.D. Tex. 2003).

beneficiaries of the director's fiduciary duties, for the stock ownership would tend to ally the director with the interests of the shareholders rather than the creditors, but relatively insubstantial amounts of stock ownership should not impugn director independence.⁶⁰⁹

In *Pereira v. Cogan*,⁶¹⁰ a Chapter 7 trustee bought an adversary proceeding against Marshall Cogan, the former CEO of a closely held Delaware corporation of which he was the founder and majority stockholder, and the corporation's other officers and directors for their alleged self-dealing or breach of fiduciary duty.⁶¹¹ The U.S. District Court for the Southern District of New York ("*SDNY*") held *inter alia*, that (1) ratification by board of directors that was not independent⁶¹² of compensation that the CEO had previously set for himself, without

⁶⁰⁹ *In re IT Group Inc.*, Civ. A. 04-1268-KAJ, 2005 WL 3050611, at *1 (D. Del. 2005) (plaintiff sufficiently alleged breach of loyalty based upon allegation that directors were "beholden" to shareholders that received transfers in the vicinity of insolvency); *Healthco Int'l, Inc. v. Hicks, Muse & Co. (In re Healthco Int'l Inc.)*, 195 B.R. 971, 976 (Bankr. D. Mass. 1966) (refusing to dismiss breach of fiduciary duty claims against director of the corporation arising from failed leverage buyout because director was also controlling shareholder who benefited from leveraged buyout); *cf. Angelo, Gordon & Co., L.P. v. Allied Riser Commc'ns Corp.*, 805 A.2d 221, 222 (Del. Ch. 2002).

⁶¹⁰ 294 B.R. 449, 463 (S.D.N.Y. 2003).

⁶¹¹ The Court noted the following:

Once Cogan created the cookie jar—and obtained outside support for it—he could not without impunity take from it.

The second and more difficult question posed by this lawsuit is what role the officers and directors should play when confronted by, or at least peripherally aware of, the possibility that a controlling shareholder (who also happens to be their boss) is acting in his own best interests instead of those of the corporation. Given the lack of public accountability present in a closely held private corporation, it is arguable that such officers and directors owe a greater duty to the corporation and its shareholders to keep a sharp eye on the controlling shareholder. At the very least, they must uphold the same standard of care as required of officers and directors of public companies or private companies that are not so dominated by a founder/controlling shareholder. They cannot turn a blind eye when the controlling shareholder goes awry, nor can they simply assume that all's right with the corporation without any exercise of diligence to ensure that that is the case.

As discussed later, it is found as a matter of fact that Trace was insolvent or in the vicinity of insolvency during most of the period from 1995 to 1999, when Trace finally filed for bankruptcy. Trace's insolvency means that Cogan and the other director and officer defendants were no longer just liable to Trace and its shareholders, but also to Trace's creditors. In addition, the insolvency rendered certain transactions illegal, such as a redemption and the declaring of dividends. It may therefore be further concluded that, in determining the breadth of duties in the situation as described above, officers and directors must at the very least be sure that the actions of the controlling shareholder (and their inattention thereto) do not run the privately held corporation into the ground.

Pereira v. Cogan, 294 B.R. at 463.

⁶¹² The Court also commented:

Cogan also failed in his burden to demonstrate that the Committee or the Board was "independent" in connection with the purported ratification of his compensation. Sherman, the only member of the Board not on Trace's payroll, was a long-time business associate and personal friend of Cogan, with whom he had other overlapping business interests. Nelson, the only other member of the Committee, was Trace's CFO and was dependent on Cogan both for his employment and the amount of his compensation, as were Farace and Marcus, the other Board members who approved the Committee's ratification of Cogan's compensation. There

adequate information-gathering, was insufficient to shift from CEO the burden of demonstrating entire fairness of transaction; (2) corporate officers with knowledge of debtor's improper redemption of preferred stock from an unaffiliated stockholder and unapproved loans to the CEO and related persons could be held liable on breach of fiduciary duty theory for failing to take appropriate action; (3) directors, by abstaining from voting on challenged corporate expenditures, could not insulate themselves from liability; (4) directors did not satisfy their burden of demonstrating "entire fairness" of transactions, and were liable for any resulting damages; (5) report prepared by corporation's compensation committee on performance/salary of CEO, which was prepared without advice of outside consultants and consisted of series of conclusory statements concerning the value of services rendered by the CEO in obtaining financing for the corporation was little more than an *ipse dixit*, on which corporate officers could not rely;⁶¹³ (6) term "redeem," as used in DGCL § 160, providing that no corporation shall redeem its shares when the capital of the corporation is impaired, was broad enough to include transaction whereby corporation loaned money to another entity to purchase its shares, the other entity used money to purchase shares, and the corporation then accepted shares as collateral for loan; (7) officers and directors could not assert individual-based offsets as defenses to breach of fiduciary duty claims; (8) the exculpatory clause in the corporation's certificate of incorporation which shields directors from liability to the corporation for breach of the duty of care, as authorized by DGCL § 102(b)(7), was inapplicable because the trustee had brought the action for the benefit of the creditors rather than the corporation; and (9) the business judgment rule was not applicable because a majority of the challenged transactions were not the subject of board

is no evidence that any member of the Committee or the Board negotiated with Cogan over the amount of his compensation, much less did so at arm's length.

Id. at 478.

⁶¹³

The Court further noted:

With regard to the ratification of Cogan's compensation from 1988 to 1994, there is no evidence that the Board met to discuss the ratification or that the Board actually knew what level of compensation they were ratifying. While Nelson delivered a report on Cogan's 1991-1994 compensation approximately two years prior to the ratification, on June 24, 1994, there is no evidence that the directors who ratified the compensation remembered that colloquy, nor that they relied on their two-year-old memories of it in deciding to ratify Cogan's compensation. The mere fact that Cogan had successfully spearheaded extremely lucrative deals for Trace in the relevant years and up to the ratification vote is insufficient to justify a blind vote in favor of compensation that may or may not be commensurate with those given to similarly situated executives. Any blind vote is suspect in any case given the fact that Cogan dominated the Board.

The most that the Board did, or even could do, based on the evidence presented, was to rely on the recommendation of the Compensation Committee. They have not established reasonable reliance on the advice of the Compensation Committee, then composed of Nelson and Sherman (two of the four non-interested Board members who ratified the compensation). The Compensation Committee had never met. It did not seek the advice of outside consultants. The "report" to the Board consisted of several conclusory statements regarding Cogan's performance, without reference to any attachments listing how much the compensation was or any schedule pitting that level of compensation against that received by executives the Compensation Committee believed to be similarly situated. The "report" was little more than an *ipse dixit* and it should have been treated accordingly by the Board. As a result, the director-defendants cannot elude liability on the basis of reliance on the Compensation Committee's report.

Id. at 528.

action. The SDNY concluded that the trustee’s fiduciary duty and DGCL claims were in the nature of equitable restitution, rather than legal damages, and denied defendants’ request for a jury trial. The CEO was found liable for \$44.4 million and then settled with the trustee. The remaining defendants appealed to the Second Circuit.

On appeal the defendants raised a “sandstorm” of claims and ultimately prevailed. The Second Circuit held in *Pereira v. Farace*⁶¹⁴ that the defendants were entitled to a jury trial because the trustee’s claims were principally a legal action for damages, rather than an equitable claim for restitution or unjust enrichment, because the appealing defendants never possessed the funds at issue (the CEO who had received the funds had previously settled with the trustee and was not a party to the appeal). In remanding the case for a jury trial, the Second Circuit also held (i) that the bankruptcy trustee stood in the shoes of the insolvent corporation and as such was bound by the exculpatory provision in the corporation’s certificate of incorporation pursuant to DGCL § 102(b)(7) which precluded shareholder claims based on mismanagement (i.e., the duty of care)⁶¹⁵ and (ii) that the SDNY did not properly apply the Delaware definition of insolvency when it used a cash flow test of insolvency which projected into the future whether the corporation’s capital will remain adequate over a period of time rather than the Delaware test which looks solely at whether the corporation has been paying its bills on a timely basis and/or whether its assets exceed its liabilities.

When the conduct of the directors is being challenged by the creditors on fiduciary duty of loyalty grounds, the directors do not have the benefit of the statutes limiting director liability in duty of care cases.⁶¹⁶

(e) Deepening Insolvency. Deepening insolvency as a legal theory can be traced to dicta in a 1983 Seventh Circuit opinion that “the corporate body is ineluctably damaged by the deepening of its insolvency,” which results from the “fraudulent prolongation of a corporation’s life beyond insolvency.”⁶¹⁷ While bankruptcy and other federal courts are frequently the forum in which deepening insolvency claims are litigated, the cause of action or theory of damages (if recognized) would be a matter of state law.⁶¹⁸ In recent years some federal courts embraced

⁶¹⁴ 413 F.3d 330, 336 (2d Cir. 2005).

⁶¹⁵ Other cases have held that director exculpation charter provisions adopted under DGCL § 102(b)(7) protect directors from duty of care claims brought by creditors who were accorded standing to pursue fiduciary duty claims against directors because the company was insolvent. *Production Resources Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 792 (Del. Ch. 2004) (“[T]he fact of insolvency does not change the primary object of the director’s duties, which is the firm itself. The firm’s insolvency simply makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm’s value and logically gives them standing to pursue these claims to rectify that injury.”); *Continuing Creditors’ Comm. of Star Telecomms. Inc. v. Edgecomb*, 385 F. Supp. 2d 449, 463 (D. Del. 2004); *In re Verestar, Inc.*, 343 B.R. 444, 454 (Bankr. S.D.N.Y. 2006); *In re Greater Southeast Community Hospital Corp.*, 333 B.R. 506, 513 (Bankr. D. Colo. 2005).

⁶¹⁶ *Geyer v. Ingersoll Pub. Co.*, 621 A. 2d 784, 789 (Del. Ch. 1992).

⁶¹⁷ *Schacht v. Brown*, 711 F.2d 1343, 1350 (7th Cir 1983); see Sabin Willett, *The Shallows of Deepening Insolvency*, 60 Bus. Law 549, 550 (Feb. 2005).

⁶¹⁸ *In re CITX Corp. Inc.*, 448 F.3d 672, 680-81 (3d Cir. 2006) (holding, where a Bankruptcy Trustee sued the debtor’s accountant for malpractice that deepened the debtor’s insolvency, breach of fiduciary duty and negligent misrepresentation, that only fraudulent conduct would suffice to support a deepening insolvency claim (with fraud requiring proof of “a representation of material fact, falsity, scienter, reliance and injury”)

deepening insolvency claims and predicted that Delaware would recognize such a cause of action.⁶¹⁹ In *Trenwick America Litigation Trust v. Ernst & Young LLP*,⁶²⁰ the Delaware Court of Chancery in 2006 for the first time addressed a cause of action for deepening insolvency and, confounding the speculation of the federal courts, held that “put simply, under Delaware law, ‘deepening insolvency’ is no more of a cause of action when a firm is insolvent than a cause of action for ‘shallowing profitability’ would be when a firm is solvent.”⁶²¹ This holding, which was affirmed by the Delaware Supreme Court on August 4, 2007, “on the basis of and for the reasons assigned by the Court of Chancery in its opinion,”⁶²² arose in the aftermath of two flawed public company acquisitions which were blamed for the company’s troubles.

While it established (at least in Delaware) that deepening insolvency is not a cause of action, *Trenwick* expressly left the door open for claims based on existing causes of action such as breach of fiduciary duty, fraud, fraudulent conveyance and breach of contract. Creditors looking for other pockets to satisfy their claims have attempted to plead their claims relating to actions by directors, officers and professionals that, while attempting to save the business, only prolonged its agony and delayed its demise to fit the opening left by *Trenwick*. These attempts have met with mixed results. In *Radnor Holdings*, a Bankruptcy Court in Delaware dismissed claims that directors had breached their fiduciary duties to the company by authorizing it to borrow to “swing for the fences” in an aggressive new venture as no more than a “disguised” deepening insolvency claim.⁶²³ Then in *Brown Schools*, another Bankruptcy Court in Delaware dismissed a cause of action for deepening insolvency based on *Trenwick*, but declined to dismiss duty of loyalty claims for self-dealing against a controlling stockholder/creditor and its representatives in causing the company to take actions intended to elevate their claims as creditors.⁶²⁴

and declining to allow a claim alleging that negligent conduct caused a deepening insolvency; the Third Circuit also held that deepening insolvency was not a valid theory of damages supporting a professional malpractice claim against the accounting firm).

⁶¹⁹ *Official Comm. of Unsecured Creditors v. R.F. Lafferty Co., Inc.*, 267 F.3d 340, 351 (3d Cir. 2001) (applying Pennsylvania law); *In re Exide v. Credit Suisse First Boston*, 299 B.R. 732, 735 (Bankr. D. Del. 2003); *In re Scott Acquisition Corp.*, 344 B.R. 283, 284 (Bankr. D. Del.); *Stanziale v. Pepper Hamilton, LLP, (In re Student Fin. Corp.)*, 335 B.R. 539, 548 (D. Del. 2005).

⁶²⁰ 906 A.2d 168, 172 (Del. Ch. 2006).

⁶²¹ *Id.* at 174.

⁶²² *Trenwick Am. Litig. Trust v. Billett*, 931 A.2d 438, 2007 WL 2317768, at *1 (Del. 2007).

⁶²³ *Official Comm. of Unsecured Creditors of Radnor Holdings Corp. v. Tennenbaum Capital Partners LLC (In re Radnor Holdings Corp.)*, 353 B.R. 820, 843 (Bankr. D. Del. 2006).

⁶²⁴ *Miller v. McCown De Leeuw & Co. (In re Brown Schools)*, 386 B.R. 37, 46 (Bankr. D. Del. Apr. 24, 2008). In distinguishing *Radnor*, the Bankruptcy Court wrote in *Brown Schools*:

The *Radnor* Court noted that the plaintiff’s complaint against the board only alleged duty of care violations, not duty of loyalty breaches as alleged in this case. *Radnor*, 353 B.R. at 842. Under Delaware law, a plaintiff asserting a duty of care violation must prove the defendant’s conduct was grossly negligent in order to overcome the deferential business judgment rule. * * * Duty of care violations more closely resemble causes of action for deepening insolvency because the alleged injury in both is the result of the board of directors’ poor business decision. To defeat such an action, a defendant need only prove that the process of reaching the final decision was not the result of gross negligence. Therefore,

(f) Conflicts of Interest. Conflicts of interest are usually present in closely held corporations where the shareholders are also directors and officers. While the Tex. Corp. Stats. and the DGCL allow transactions with interested parties after disclosure and disinterested director or shareholder approval,⁶²⁵ the conflict of interest rules may change in an insolvency situation.⁶²⁶

(g) Fraudulent Transfers. Both state and federal law prohibit fraudulent transfers.⁶²⁷ All require insolvency at the time of the transaction. The Texas and Delaware fraudulent transfer statutes are identical to the Uniform Fraudulent Transfer Act, except Delaware adds the following provision: “Unless displaced by the provisions of this chapter, the principles of law and equity, including the law merchant and the law relating to principal and agent, estoppel, laches, fraud, misrepresentation, duress, coercion, mistake, insolvency or other validating or invalidating cause, supplement its provisions.”⁶²⁸

2.6.10. Executive Compensation Process.

(a) Fiduciary Duties. Decisions regarding the compensation of management are among the most important and controversial decisions that a Board can make.⁶²⁹ The shareholders and management both want management to be compensated sufficiently so they feel amply rewarded for their efforts in making the entity a profitable investment for the shareholders, are motivated to work hard for the success of the entity, and are able to attract and retain other talented executives. Executives are naturally concerned that they be fully rewarded

claims alleging a duty of care violation could be viewed as a deepening insolvency claim by another name.

For breach of the duty of loyalty claims, on the other hand, the plaintiff need only prove that the defendant was on both sides of the transaction. *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983) (“When directors of a Delaware corporation are on both sides of a transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain.”). The burden then shifts to the defendant to prove that the transaction was entirely fair. *Id.* This burden is greater than meeting the business judgment rule inherent in duty of care cases. Further, duty of loyalty breaches are not indemnifiable under the Delaware law. 8 Del. C. § 102(b)(7).

Therefore, the Court concludes that the Trustee’s claims for breach of the fiduciary duty of loyalty in the form of self-dealing are not deepening insolvency claims in disguise. Consequently, the *Trenwick* and *Radnor* decisions are not controlling.

Id. at 46-47. The Court in *Brown Schools* also allowed (i) deepening insolvency to stand as a measure of damages for duty of loyalty claims, but not duty of care claims; (ii) claims against the controlling stockholder for fraudulent transfers in respect of fees allegedly collected for which the debtor received no benefit, but not claims against directors and company counsel serving the debtor at the stockholder’s behest for aiding and abetting the fraudulent transfers; and (iii) against the directors and counsel for aiding and abetting the alleged self-dealing.

⁶²⁵ See *supra* notes 562-570 and related text (discussing TBOC § 21.418 and TBCA art. 2.35-1).

⁶²⁶ See *Kahn v. Lynch Commc’ns Sys., Inc.*, 638 A.2d 1110, 1115 (Del. 1994).

⁶²⁷ TEX. BUS. COM. CODE 24; DEL. CODE ANN. tit. 6, § 1301 et seq.; 11 U.S.C. § 548; see Byron F. Egan, *Special Issues in Asset Acquisitions*, ABA 13th Annual Nat’l Inst. on Negotiating Bus. Acquisitions, Nov. 6, 2008, at 123-25, <http://www.jw.com/site/jsp/publicationinfo.jsp?id=1043>.

⁶²⁸ DEL. CODE ANN. tit. 6, § 1310.

⁶²⁹ See Bruce F. Dravis, *The Role of Independent Directors after Sarbanes-Oxley*, 79 (ABA Bus. Sec. 2007).

and provided significant incentives. The shareholders, however, are also mindful that amounts paid to management reduce the profits available for the shareholders, want pay to be linked to performance, and may challenge compensation that they deem excessive in the media, in elections of directors and in the courts.

As the situation is fraught with potential conflicts, Boards often delegate the power and responsibility for setting executive compensation to a committee of directors (a “*compensation committee*”), typically composed of independent directors.⁶³⁰ The objective is to follow a process that will resolve the inherent conflicts of interest,⁶³¹ comply with the requirements of SOX and other applicable laws,⁶³² and satisfy the fiduciary duties of all involved.

The fiduciary duties discussed elsewhere herein, including the duties of care, loyalty and disclosure, are all applicable when directors consider executive compensation matters. As in other contexts, process and disinterested judgment are critical.

(b) Specific Cases.

Walt Disney. In respect of directors’ fiduciary duties in approving executive compensation, the Delaware Supreme Court’s opinion dated June 8, 2006, in *In re The Walt Disney Co. Derivative Litigation*,⁶³³ which resulted from the failed marriage between Disney and its former President Michael Ovitz, and the Chancery Court decisions which preceded it are instructive. The Delaware Supreme Court affirmed the Delaware Court of Chancery’s determination after a thirty-seven day trial⁶³⁴ that Disney’s directors had not breached their fiduciary duties in connection with the hiring or termination of Michael Ovitz as President of

⁶³⁰ See *id.* at 79-82.

⁶³¹ In *Wal-Mart Stores, Inc. v. Coughlin*, 255 S.W.3d 424, 428 (Ark. 2007), Wal-Mart was able to set aside a very expensive settlement and release agreement with a former executive vice president and director after a whistleblower induced internal investigation found he had effectively misappropriated hundreds of thousands of dollars in cash and property. The Arkansas Supreme Court held that the settlement and release was unambiguous and by its terms would have released the claims (the agreement provided that all claims “of any nature whatsoever, whether known or unknown,” were released). *Id.* at 428. In a case of first impression in Arkansas, the Arkansas Supreme Court held that the settlement was voidable because, in not disclosing to the corporation that he had been misappropriating corporate assets for his personal benefit prior to entering into the release, the former director/officer (1) breached his fiduciary duty of good faith and loyalty to Wal-Mart and (2) fraudulently induced Wal-Mart to enter into the release. After surveying the law from other jurisdictions, the Court wrote:

We are persuaded . . . that the majority view is correct, which is that the failure of a fiduciary to disclose material facts of his fraudulent conduct to his corporation prior to entering into a self-dealing contract with that corporation will void that contract and that material facts are those facts that could cause a party to act differently had the party known of those facts. We emphasize, however, that this duty of a fiduciary to disclose is embraced within the obligation of a fiduciary to act towards his corporation in good faith, which has long been the law in Arkansas. Stated differently, we are not adopting a new principle of fiduciary law by our holding today but simply giving voice to an obvious element of the fiduciary’s duty of good faith.

Id. at 430-31.

⁶³² See Appendix D – Effect of Sarbanes-Oxley Act of 2002 on Common Law Fiduciary Duties.

⁶³³ 906 A.2d 27, 35 (Del. 2006).

⁶³⁴ *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 697 (Del. Ch. 2005).

The Walt Disney Company. In so ruling, the Delaware Supreme Court clarified the parameters of the obligation of corporate fiduciaries to act in good faith and offered helpful guidance about the types of conduct that constitute “bad faith.” This *Disney* litigation also emphasizes the importance of corporate minutes and their contents in a court’s determination whether directors have satisfied their fiduciary duties.⁶³⁵

Facts. The facts surrounding the *Disney* saga involved a derivative suit against Disney’s directors and officers for damages allegedly arising out of the 1995 hiring and the 1996 firing of Michael Ovitz. The termination resulted in a non-fault termination payment to Ovitz under the terms of his employment agreement valued at roughly \$140 million (including the value of stock options). The shareholder plaintiffs alleged that the Disney directors had breached their fiduciary duties both in approving Ovitz’s employment agreement and in later allowing the payment of the non-fault termination benefits.

Chancery Court Opinions. On September 10, 2004, the Chancery Court ruled on defendant Ovitz’ motion for summary judgment as follows: (i) as to claims based on Ovitz entering into his employment agreement with Disney, the Court granted summary judgment for Ovitz confirming that “before becoming a fiduciary, Ovitz had the right to seek the best employment agreement possible for himself,” and endorsing a bright line rule that “officers and directors become fiduciaries only when they are officially installed, and receive the formal investiture of authority that accompanies such office or directorship . . .”; and (ii) as to claims based on actions after he became an officer, (a) “an officer may negotiate his or her own employment agreement as long as the process involves negotiations performed in an adversarial and arms-length manner”; (b) “Ovitz made the decision that a faithful fiduciary would make by abstaining from attendance at a [Compensation Committee] meeting [of which he was an ex officio member] where a substantial part of his own compensation was to be discussed and decided upon”; (c) Ovitz did not breach any fiduciary duties by executing and performing his employment agreement after he became an officer since no material change was made in it from the form negotiated and approved prior to his becoming an officer; (d) in negotiating his no fault termination, his conduct should be measured under DGCL § 144 [interested transactions not void if approved by disinterested board or shareholders after full disclosure]; but (e) since his termination involved some negotiation for additional benefits, there was a fact question as to whether he improperly colluded with other side of table in the negotiations and “whether a majority of any group of disinterested directors ever authorized the payment of Ovitz severance payments Absent a demonstration that the transaction was fair to Disney, the transaction may be voidable at the discretion of the company.”⁶³⁶

On August 9, 2005, the Chancery Court rendered an opinion after a thirty-seven day trial on the merits in this *Disney* case in which he concluded that the defendant directors did not breach their fiduciary duties or commit waste in connection with the hiring and termination of Michael Ovitz.

⁶³⁵ Cullen M. “Mike” Godfrey, *In re The Walt Disney Company Derivative Litigation – A New Standard for Corporate Minutes*, BUS. L. TODAY, Vol. 17, No. 6 (July/Aug. 2008).

⁶³⁶ C.A. No. 15452, 2004 WL 2050138, at *7 (Del. Ch. Sept. 10, 2004).

June 8, 2006 Supreme Court Opinion. The Delaware Supreme Court affirmed the Court of Chancery’s conclusion that the shareholder plaintiffs had failed to prove that the defendants had breached any fiduciary duty.⁶³⁷ With respect to the hiring of Ovitz and the approval of his employment agreement, the Delaware Supreme Court held that the Court of Chancery had a sufficient evidentiary basis from which to conclude, and had properly concluded, that the defendants had not breached their fiduciary duty of care and had not acted in bad faith. As to the ensuing no-fault termination of Ovitz and the resulting termination payment pursuant to his employment agreement, the Delaware Supreme Court affirmed the Chancery Court’s holdings that the full board did not (and was not required to) approve Ovitz’s termination, that Michael Eisner, Disney’s CEO, had authorized the termination, and that neither Eisner, nor Sanford Litvack, Disney’s General Counsel, had breached his duty of care or acted in bad faith in connection with the termination.

In its opinion, the Delaware Supreme Court provided the following color as to the meaning of “good faith” in Delaware fiduciary duty jurisprudence:

The precise question is whether the Chancellor’s articulated standard for bad faith corporate fiduciary conduct—intentional dereliction of duty, a conscious disregard for one’s responsibilities—is legally correct. In approaching that question, we note that the Chancellor characterized that definition as “an appropriate (*although not the only*) standard for determining whether fiduciaries have acted in good faith.” That observation is accurate and helpful, because as a matter of simple logic, at least three different categories of fiduciary behavior are candidates for the “bad faith” pejorative label.

The first category involves so-called “subjective bad faith,” that is, fiduciary conduct motivated by an actual intent to do harm. That such conduct constitutes classic, quintessential bad faith is a proposition so well accepted in the liturgy of fiduciary law that it borders on axiomatic. We need not dwell further on this category, because no such conduct is claimed to have occurred, or did occur, in this case.

The second category of conduct, which is at the opposite end of the spectrum, involves lack of due care—that is, fiduciary action taken solely by reason of gross negligence and without any malevolent intent. In this case, appellants assert claims of gross negligence to establish breaches not only of director due care but also of the directors’ duty to act in good faith. Although the Chancellor found, and we agree, that the appellants failed to establish gross negligence, to afford guidance we address the issue of whether gross negligence (including a failure to inform one’s self of available material facts), without more, can also constitute bad faith. The answer is clearly no.

* * *

⁶³⁷ *In re The Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 35 (Del. 2006). The Delaware Supreme Court wrote: “We conclude . . . that the Chancellor’s factual findings and legal rulings were correct and not erroneous in any respect.” *Id.*

The Delaware General Assembly has addressed the distinction between bad faith and a failure to exercise due care (*i.e.*, gross negligence) in two separate contexts. The first is Section 102(b)(7) of the DGCL, which authorizes Delaware corporations, by a provision in the certificate of incorporation, to exculpate their directors from monetary damage liability for a breach of the duty of care. That exculpatory provision affords significant protection to directors of Delaware corporations. The statute carves out several exceptions, however, including most relevantly, “for acts or omissions not in good faith. . . .” Thus, a corporation can exculpate its directors from monetary liability for a breach of the duty of care, but not for conduct that is not in good faith. To adopt a definition of bad faith that would cause a violation of the duty of care automatically to become an act or omission “not in good faith,” would eviscerate the protections accorded to directors by the General Assembly’s adoption of Section 102(b)(7).

A second legislative recognition of the distinction between fiduciary conduct that is grossly negligent and conduct that is not in good faith, is Delaware’s indemnification statute, found at 8 *Del. C.* § 145. To oversimplify, subsections (a) and (b) of that statute permit a corporation to indemnify (*inter alia*) any person who is or was a director, officer, employee or agent of the corporation against expenses (including attorneys’ fees), judgments, fines and amounts paid in settlement of specified actions, suits or proceedings, where (among other things): (i) that person is, was, or is threatened to be made a party to that action, suit or proceeding, and (ii) that person “acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation. . . .” Thus, under Delaware statutory law a director or officer of a corporation can be indemnified for liability (and litigation expenses) incurred by reason of a violation of the duty of care, but not for a violation of the duty to act in good faith.

Section 145, like Section 102(b)(7), evidences the intent of the Delaware General Assembly to afford significant protections to directors (and, in the case of Section 145, other fiduciaries) of Delaware corporations. To adopt a definition that conflates the duty of care with the duty to act in good faith by making a violation of the former an automatic violation of the latter, would nullify those legislative protections and defeat the General Assembly’s intent. There is no basis in policy, precedent or common sense that would justify dismantling the distinction between gross negligence and bad faith.

That leaves the third category of fiduciary conduct, which falls in between the first two categories of (1) conduct motivated by subjective bad intent and (2) conduct resulting from gross negligence. This third category is what the Chancellor’s definition of bad faith—intentional dereliction of duty, a conscious disregard for one’s responsibilities—is intended to capture. The question is whether such misconduct is properly treated as a non-exculpable, non-indemnifiable violation of the fiduciary duty to act in good faith. In our view it must be, for at least two reasons.

First, the universe of fiduciary misconduct is not limited to either disloyalty in the classic sense (i.e., preferring the adverse self-interest of the fiduciary or of a related person to the interest of the corporation) or gross negligence. Cases have arisen where corporate directors have no conflicting self-interest in a decision, yet engage in misconduct that is more culpable than simple inattention or failure to be informed of all facts material to the decision. To protect the interests of the corporation and its shareholders, fiduciary conduct of this kind, which does not involve disloyalty (as traditionally defined) but is qualitatively more culpable than gross negligence, should be proscribed. A vehicle is needed to address such violations doctrinally, and that doctrinal vehicle is the duty to act in good faith.

* * *

Second, the legislature has also recognized this intermediate category of fiduciary misconduct, which ranks between conduct involving subjective bad faith and gross negligence. Section 102(b)(7)(ii) of the DGCL expressly denies money damage exculpation for “acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law.” By its very terms that provision distinguishes between “intentional misconduct” and a “knowing violation of law” (both examples of subjective bad faith) on the one hand, and “acts . . . not in good faith,” on the other. Because the statute exculpates directors only for conduct amounting to gross negligence, the statutory denial of exculpation for “acts . . . not in good faith” must encompass the intermediate category of misconduct captured by the Chancellor’s definition of bad faith.⁶³⁸

In addition to the helpful discussion about the contours of the duty of good faith, the Delaware Supreme Court’s opinion offers guidance on several other issues. For example, the Delaware Supreme Court affirmed the Chancellor’s rulings relating to the power of Michael Eisner, as Disney’s CEO, to terminate Mr. Ovitz as President.⁶³⁹ The Delaware Supreme Court also adopted the same practical view as the Court of Chancery regarding the important statutory protections offered by DGCL § 141(e), which permits corporate directors to rely in good faith on information provided by fellow directors, board committees, officers, and outside consultants.

The Court also found plaintiffs had “not come close to satisfying the high hurdle required to establish waste” as the Board’s approval of Ovitz’s employment agreement “had a rational business purpose: to induce Ovitz to leave [his prior position], at what would otherwise be a considerable cost to him, in order to join Disney.”⁶⁴⁰

⁶³⁸ *Id.* at 64-67 (internal citations and footnotes omitted).

⁶³⁹ See Marc I. Steinberg & Matthew D. Bivona, *Disney Goes Goofy: Agency, Delegation, and Corporate Governance*, 60 HASTINGS L.J., 201 (Dec. 2008) (questioning the holding that CEO Eisner had the authority to terminate Ovitz without cause under traditional principles of agency and corporate law).

⁶⁴⁰ *Id.* at 75.

Integrated Health. In *Official Committee of Unsecured Creditors of Integrated Health Services, Inc. v. Elkins*,⁶⁴¹ plaintiff alleged that CEO breached his fiduciary duty of loyalty to the corporation by improperly obtaining certain compensation arrangements and that the directors (other than the CEO) breached their duty of loyalty by (1) subordinating the best interests of Integrated Health to their allegiance to the CEO, by failing to exercise independent judgment with respect to certain compensation arrangements, (2) failing to select and rely on an independent compensation consultant to address the CEO's compensation arrangements, and (3) participating in the CEO's breaches of fiduciary duty by approving or ratifying his actions. The plaintiff also alleged that each of the defendant directors breached his fiduciary duty of care by (i) approving or ratifying compensation arrangements without adequate information, consideration or deliberation, (ii) failing to exercise reasonable care in selecting and overseeing the compensation expert, and (iii) failing to monitor how the proceeds of loans to the CEO were utilized by him. The Chancery Court declined to dismiss the *bad faith* and breach of loyalty claims against the CEO himself, adopting the *Disney* standard that once an employee becomes a fiduciary of an entity, he had a duty to negotiate further compensation arrangements "honestly and in good faith so as not to advantage himself at the expense of the [entity's] shareholders," but that such requirement did not prevent fiduciaries from negotiating their own employment agreements so long as such negotiations were "performed in an adversarial and arms-length manner."

As to whether any of the challenged transactions was authorized with the kind of intentional or conscious disregard that avoided the DGCL § 102(b)(7) exculpatory provision defense, the Court wrote that in the May 28, 2003 *Disney* decision the Chancellor determined that the complaint adequately alleged that the defendants consciously and intentionally disregarded their responsibilities, and wrote that while there may be instances in which a Board may act with deference to corporate officers' judgments, executive compensation was not one of those instances: "The board must exercise its own business judgment in approving an executive compensation transaction."⁶⁴² Since the case involved a motion to dismiss based on the DGCL § 102(b)(7) provision in the corporation's certificate of incorporation, the plaintiff must plead facts that, if true, would show that the Board consciously and intentionally disregarded its responsibilities (as contrasted with being only grossly negligent). Examining each of the specific compensation pieces attacked in the pleadings, the Court found that the following alleged facts met such conscious and intentional standard: (i) loans from the corporation to the CEO that were initiated by the CEO were approved by the compensation committee and the Board only after the loans had been made; (ii) the compensation committee gave approval to loans even though it was given no explanation as to why the loans were made; (iii) the Board, without additional investigation deliberation, consultation with an expert or determination as to what the compensation committee's decision process was, ratified loans (loan proceeds were received prior to approval of loans by the compensation committee); (iv) loan forgiveness provisions were extended by unanimous written consent without any deliberation or advice from any expert; (v) loans were extended without deliberation as to whether the corporation received any consideration for the loans; and (vi) there were no identified corporate authorizations or analysis of the costs to the corporation or the corporate reason therefor performed either by the

⁶⁴¹ C.A. No. 20228-NC, 2004 WL 1949290, at *1 (Del. Ch. Aug. 24, 2004).

⁶⁴² *Id.* at *12.

compensation committee or other members of the Board with respect to the provisions in CEO's employment contract that gave him large compensation if he departed from the company.

Distinguishing between the alleged total lack of deliberation discussed in *Disney* and the alleged inadequate deliberation in *Integrated Health*, the Chancery Court wrote:

Thus, a change in characterization from a *total* lack of deliberation (and for that matter a difference between the meaning of discussion and deliberation, if there is one), to even a short conversation may change the outcome of a *Disney* analysis. Allegations of nondeliberation are different from allegations of not enough deliberation.⁶⁴³

Later in the opinion, in granting a motion to dismiss with respect to some of the compensation claims, the Chancery Court suggested that arguments as to what would be a reasonable length of time for board discussion or what would be an unreasonable length of time for the Board to consider certain decisions were not particularly helpful in evaluation a fiduciary duty claim:

As long as the Board engaged in action that can lead the Court to conclude it did not act in knowing and deliberate indifference to its fiduciary duties, the inquiry of this nature ends. The Court does not look at the *reasonableness* of a Board's actions in this context, as long as the Board exercised *some* business judgment.⁶⁴⁴

In the end, the Chancery Court upheld claims alleging that no deliberation occurred concerning certain elements of compensation to Elkins, but dismissed claims alleging that some (but inadequate) deliberation occurred. Further, the decision upheld claims alleging a failure to consult with a compensation expert as to some elements of compensation, but dismissed claims alleging that the directors consulted for too short a period of time with the compensation expert who had been chosen by the CEO and whose work had been reviewed by the CEO in at least some instances prior to being presented to directors. Thus, it appears that directors who give some attention to an issue, as opposed to none, will have a better argument that they did not consciously and intentionally disregard their responsibilities.

Sample v Morgan. In *Sample v. Morgan*,⁶⁴⁵ the plaintiff alleged a variety of breaches of director fiduciary duties, including the duties of disclosure and loyalty, in connection with the Board's action in seeking approval from the company's stockholders for a certificate of incorporation amendment (the "Charter Amendment") and a Management Stock Incentive Plan (the "Incentive Plan"). When the use of the incentive plan shares was disclosed, plaintiff filed suit in the Delaware Chancery Court, alleging that the grant of the new shares was a wasteful entrenchment scheme designed to ensure that the insider majority of the Board would retain control of the company and that the stockholders' approval of the Charter Amendment and the Incentive Plan were procured through materially misleading disclosures. The complaint noted that the directors failed to disclose that the Charter Amendment and Incentive Plan had resulted

⁶⁴³ *Id.* at *13 n.58.

⁶⁴⁴ *Id.* at *14. Vice Chancellor Noble wrote: "The Compensation Committee's signing of unanimous written consents in this case raises a concern as to whether it acted with knowing and deliberate indifference." *Id.*

⁶⁴⁵ 914 A.2d 647, 650 (Del. Ch. 2007).

from planning between the company's outside counsel – the same one who eventually served as the sole advisor to the Compensation Committee that decided to award all of the new shares to the insider majority at the cheapest possible price and with immediate voting and dividend rights – and the company's CEO. Also not disclosed to the stockholders was the fact that the company had entered into a contract with the buyer of the company's largest existing bloc of shares simultaneously with the Board's approval of the Charter Amendment and the Incentive Plan which provided that for five years thereafter the company would not issue any shares in excess of the new shares that were to be issued if the Charter Amendment and Incentive Plan were approved. Thus, the stockholders were not told that they were authorizing the issuance to management of the only equity the company could issue for five years, nor were they told that the Board knew this when it approved the contract, the Charter Amendment, and the Incentive Plan all at the same meeting. In denying defendants' motion to dismiss, the Court wrote:

The complaint plainly states a cause of action. Stockholders voting to authorize the issuance of 200,000 shares comprising nearly a third of the company's voting power in order to "attract[] and retain[] key employees" would certainly find it material to know that the CEO and company counsel who conjured up the Incentive Plan envisioned that the entire bloc of shares would go to the CEO and two other members of top management who were on the board. A rational stockholder in a small company would also want to know that by voting yes on the Charter Amendment and Incentive Plan, he was authorizing management to receive the only shares that the company could issue during the next five years due to a contract that the board had simultaneously signed with the buyer of another large bloc of shares.

In view of those non-disclosures, it rather obviously follows that the brief meetings at which the Compensation Committee, relying only the advice of the company counsel who had helped the Insider Majority develop a strategy to secure a large bloc that would deter takeover bids, bestowed upon the Insider Majority all 200,000 shares do not, as a matter of law, suffice to require dismissal of the claim that those acts resulted from a purposeful scheme of entrenchment and were wasteful. The complaint raises serious questions about what the two putatively independent directors who comprised the Compensation Committee knew about the motivation for the issuance, whether they were complicitous with the Insider Majority and company counsel's entrenchment plans, and whether they were adequately informed about the implications of their actions in light of their reliance on company counsel as their sole source of advice.

As important, the directors do not explain how subsequent action of the board in issuing shares to the Insider Majority could cure the attainment of stockholder approval through disclosures that were materially misleading. To that point, the directors also fail to realize that the contractual limitation they placed on their ability to raise other equity capital bears on the issue of whether the complaint states a claim for relief. Requiring the Insider Majority to relinquish their equity in order to give the company breathing room to issue other equity capital without violating the contract is a plausible remedy that might be ordered at a later stage.

Finally, although the test for waste is stringent, it would be error to determine that the board could not, as a matter of law, have committed waste by causing the company to go into debt in order to give a tax-free grant of nearly a third of the company's voting power and dividend stream to existing managers with entrenchment motives and who comprise a majority of the board in exchange for a tenth of a penny per share. If giving away nearly a third of the voting and cash flow rights of a public company for \$200 in order to retain managers who ardently desired to become firmly entrenched just where they were does not raise a pleading-stage inference of waste, it is difficult to imagine what would.⁶⁴⁶

After the Court's decision on the motion to dismiss, the plaintiff amended the complaint to state claims for aiding and abetting breaches of fiduciary duty against the company counsel who had structured the challenged transactions for the Insider Majority, Baker & Hostetler LLP and a Columbus, Ohio based partner who led the representation. The law firm and partner moved to dismiss the claims against them solely on the grounds that the Delaware court lacked personal jurisdiction over them. In denying this motion to dismiss, the Court determined that the non-Delaware lawyer and his non-Delaware law firm who provided advice on Delaware law to the Delaware corporation and caused a charter amendment to be filed with the Delaware Secretary of State are subject to personal jurisdiction in Delaware courts.⁶⁴⁷

Ryan v Gifford. *Ryan v. Gifford*⁶⁴⁸ was a derivative action involving options backdating, a practice that involves the granting of options under a stock option plan approved by the issuer's stockholders which requires that the option exercise price not be less than the market price of the underlying stock on the date of grant and increasing the management compensation by fixing the grant date on an earlier date when the stock was trading for less than the market price on the date of the corporate action required to effect the grant.⁶⁴⁹ Plaintiff alleged that defendants breached their fiduciary duties of due care and loyalty by approving or accepting backdated options that violated the clear terms of the stockholder approved option plans. The Court denied defendants' motion to dismiss the derivative action because plaintiff failed to first demand that the issuer commence the proceedings, ruling that because "one half of the current board members approved each challenged transaction," asking for board approval was not required.⁶⁵⁰ Turning to the

⁶⁴⁶ *Id.* at 652-53.

⁶⁴⁷ *Sample v. Morgan*, 935 A.2d 1046, 1047 (Del. Ch. 2007).

⁶⁴⁸ 918 A.2d 341, 346 (Del. Ch. 2007).

⁶⁴⁹ See Appendix E to Byron F. Egan, *How Recent Fiduciary Duty Cases Affect Advice to Directors and Officers of Delaware and Texas Corporations*, UTCLE 37th Annual Conference on Securities Regulation and Business Law, Feb. 13, 2015, available at <http://www.jw.com/publications/article/2033> (discussing options backdating issues); C. Stephen Bigler & Pamela H. Sudell, *Delaware Law Developments: Stock Option Backdating and Spring-Loading*, 40 Rev. Sec. & Comm. Reg. 115 (May 16, 2007).

⁶⁵⁰ See *Conrad v. Blank*, 940 A.2d 28, 37 (Del. Ch. 2007) (derivative claims that 17 past and current board members of Staples Inc. breached their fiduciary duties and committed corporate waste by authorizing or wrongly permitting the secret backdating of stock option grants to corporate executives; the Court held that demand was excused as these "same directors" had already conducted an investigation and took no action even though company took a \$10.8 million charge in 2006 (covering 10 years), cryptically stating only that certain options had been issued using "incorrect measurement dates"; the Court explained: "after finding substantial evidence that options were, in fact, mispriced, the company and the audit committee ended their 'review' without explanation and apparently without seeking redress of any kind. In these circumstances, it

substance of the case, the Chancellor held “that the intentional violation of a shareholder approved stock option plan, coupled with fraudulent disclosures regarding the directors’ purported compliance with that plan, constitute conduct that is disloyal to the corporation and is therefore an act in bad faith.”⁶⁵¹ The Chancellor further commented:

A director who approves the backdating of options faces at the very *least* a substantial likelihood of liability, if only because it is difficult to conceive of a context in which a director may simultaneously lie to his shareholders (regarding his violations of a shareholder-approved plan, no less) and yet satisfy his duty of loyalty. Backdating options qualifies as one of those “rare cases [in which] a transaction may be so egregious on its face that board approval cannot meet the test of business judgment, and a substantial likelihood of director liability therefore exists.” Plaintiff alleges that three members of a board *approved* backdated options, and another board member accepted them. These are sufficient allegations to raise a reason to doubt the disinterestedness of the current board and to suggest that they are incapable of impartially considering demand.

* * *

I am unable to fathom a situation where the deliberate violation of a shareholder approved stock option plan and false disclosures, obviously intended to mislead shareholders into thinking that the directors complied honestly with the shareholder-approved option plan, is anything but an act of bad faith. It certainly cannot be said to amount to faithful and devoted conduct of a loyal fiduciary. Well-pleaded allegations of such conduct are sufficient, in my opinion, to rebut the business judgment rule and to survive a motion to dismiss.⁶⁵²

The Court’s refusal to dismiss the suits on procedural grounds opened up the discovery phase of the litigation, which was marked by numerous disputes concerning jurisdiction over additional defendants and access to documents. The plaintiffs sought access to a report prepared by an outside law firm which the Special Committee engaged as Special Counsel to investigate the stock-option-backdating charges. The Chancellor rejected arguments that various communications and notes between the Special Committee and its Special Counsel were protected by the attorney-client privilege, which allows attorneys and clients to confer confidentially, or by the work product doctrine, which protects draft versions of documents

would be odd if Delaware law required a stockholder to make demand on the board of directors before suing on those very same theories of recovery.”).

⁶⁵¹ Ryan, 918 A.2d at 358.

⁶⁵² *Id.* The Court’s focus on the inability of directors consistently with their fiduciary duties to grant options that deviate from the provisions of a stockholder agreement is consistent with the statement that “Delaware law requires that the terms and conditions of stock options be governed by a written, board approved plan” in *First Marblehead Corp. v. House*, 473 F.3d 1, 6 (1st Cir. 2006), a case arising out of a former employee attempting to exercise a stock option more than three months after his resignation. In *First Marblehead* the option plan provided that no option could be exercisable more than three months after the optionee ceased to be an employee, but the former employee was never given a copy of the option plan nor told of this provision. The Court held that the employee’s breach of contract claim was barred by Delaware law because it conflicted with the plan, but that under the laws of Massachusetts the issuer’s failure to disclose this term constituted negligent misrepresentation.

related to preparation for lawsuits.⁶⁵³ The Court ruled that when the Special Committee presented the internal investigation report to the full Board, the report and related communications were not protected because (1) only the Special Committee was the client of Special Counsel and not the full Board, which included the defendant CEO and CFO whose actions were being investigated by the Special Committee, and (2) the presentation to the full Board constituted a waiver of any privileges that would have otherwise attached. The Chancellor ordered the defendants to include all the metadata associated with the documents because it was needed to determine when and how the stock-option grant dates were altered and when the Board had reviewed the metadata.

On September 16, 2008 after years of litigation, several opinions by the Chancellor, extensive discovery, four mediations and intense negotiations, the parties to the *Ryan v. Gifford* action entered into a stipulation of settlement which provided that (i) defendants and their insurance carriers would pay to the company approximately \$28.5 million in cash (of which the insurance carriers would pay \$21 million and the balance would be paid by the individual defendants; out of this sum approximately \$10 million was awarded to plaintiff's counsel for fees and expenses), (ii) mispriced options would be cancelled or repriced and (iii) governance changes would be instituted to address the conditions that led to the backdating of options, including changes in the structure of the Board and its committees and strengthened internal controls. On January 2, 2009 the Chancellor approved this settlement.⁶⁵⁴

In re Tyson Foods, Inc Consolidated Shareholder Litigation. In *In re Tyson Foods, Inc. Consolidated Shareholder Litigation*,⁶⁵⁵ plaintiffs' complaint alleged three particular types of Board malfeasance: (1) approval of consulting contracts that provided lucrative and undisclosed benefits to corporate insiders; (2) grants of "spring-loaded" stock options to insiders;⁶⁵⁶ and (3) acceptance of related-party transactions that favored insiders at the expense of shareholders. In its opinion denying a motion to dismiss allegations that the directors breached their fiduciary duties in approving compensation, the Court wrote with respect to the option spring-loading issues:

The relevant issue is whether a director acts in bad faith by authorizing options with a market-value strike price, as he is required to do by a shareholder-approved incentive option plan, at a time when he knows those shares are actually worth more than the exercise price. A director who intentionally uses inside knowledge not available to shareholders in order to enrich employees while avoiding shareholder-imposed requirements cannot, in my opinion, be said to be acting loyally and in good faith as a fiduciary.

⁶⁵³ *Ryan v. Gifford*, C.A. No. 2213-CC, 2007 WL 4259557, at *2 (Del. Ch. Dec. 3, 2007).

⁶⁵⁴ *Ryan v. Gifford*, C.A. No. 2213-CC, 2009 WL 18143, at *5 (Del. Ch. Jan. 2, 2009).

⁶⁵⁵ 919 A.2d 563, 573 (Del. Ch. 2007).

⁶⁵⁶ See Appendix E (discussing "backdated" and "spring-loaded" stock options) to Byron F. Egan, *How Recent Fiduciary Duty Cases Affect Advice to Directors and Officers of Delaware and Texas Corporations*, UTCLE 37th Annual Conference on Securities Regulation and Business Law, Feb. 13, 2015, available at <http://www.jw.com/publications/article/2033>; see C. Stephen Bigler & Pamela H. Sudell, *Delaware Law Developments: Stock Option Backdating and Spring-Loading*, 40 REV. SEC. & COMM. REG. 115 (May 16, 2007).

Valeant Pharmaceuticals v Jerney. In *Valeant Pharmaceuticals International v. Jerney*,⁶⁵⁷ the Delaware Court of Chancery in a post-trial opinion found that compensation received by a former director and president of ICN Pharmaceuticals, Inc. (now known as Valeant Pharmaceuticals International), Adam Jerney, was not entirely fair, held him liable to disgorge a \$3 million transaction bonus paid to him, and also held Jerney liable for (i) his 1/12 share (as one of 12 directors) of the costs of the special litigation committee investigation that led to the litigation and (ii) his 1/12 share of the bonuses paid by the Board to non-director employees. The Court further ordered him to repay half of the \$3.75 million in defense costs that ICN paid to Jerney and the primary defendant, ICN Chairman and CEO Milan Panic.

The *Valeant* case illustrates how compensation decisions by a Board can be challenged after a change in control by a subsequent Board. The litigation was initiated by dissident stockholders as a stockholder derivative action but, following a change in control of the Board, a special litigation committee of the Board chose to realign the corporation as a plaintiff. As a result, with the approval of the Court, ICN took over control of the litigation. During the course of discovery, ICN reached settlement agreements with all of the non-management directors, leaving Panic and Jerney as the only remaining defendants at the trial. After trial, ICN reached a settlement agreement with Panic, leaving only Jerney.

The transaction on which the bonus was paid was a reorganization of ICN into three companies; a U.S. unit, an international unit and a unit holding the rights to its antiviral medication, shares of which would be sold to the public in a registered public offering (“*IPO*”). After the IPO but before the reorganization was completed, control of the Board changed as a result of the election of additional dissident directors.

The ensuing litigation illustrates the risks to all involved when the compensation committee is not independent and disinterested. Executive compensation is like any other transaction between a corporation and its management – it is voidable unless the statutory requirements for validation of interested director transactions are satisfied.⁶⁵⁸ In Delaware a contract between a director and the director’s corporation is voidable due to the director’s interest unless (i) the transaction or contract is approved in good faith by a majority of the disinterested directors after the material facts as to the relationship or interest and as to the transaction or contract are disclosed or known to the directors, (ii) the transaction or contract is approved in good faith by shareholders after the material facts as to the relationship or interest and as to the transaction or contract is disclosed or known to the shareholders, or (iii) the transaction or contract is fair to the corporation as of the time it is authorized, approved or ratified by the directors or shareholders of the corporation.⁶⁵⁹ Neither the ICN compensation committee nor the ICN Board was disinterested because all of the directors were receiving some of the questioned bonuses.⁶⁶⁰ Since the compensation had not been approved by the

⁶⁵⁷ 921 A.2d 732, 736 (Del. Ch. 2007).

⁶⁵⁸ See *supra* notes 562-570 and related text.

⁶⁵⁹ *Id.*

⁶⁶⁰ The Court noted that each of the three directors on the compensation committee received a \$330,500 cash bonus and “were clearly and substantially interested in the transaction they were asked to consider.” *Valeant*, 921 A.2d at 739. Further, the Court commented:

stockholders, the Court applied the “entire fairness” standard⁶⁶¹ in reviewing the compensation arrangements, which placed the burden on the defendant director and officer of establishing both components of entire fairness: fair dealing and fair price. “Fair dealing” addresses the “questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained.”⁶⁶² “Fair price” requires that the transaction be substantively fair by examining “the economic and financial considerations.”⁶⁶³

The fair dealing prong of the entire fairness led the Court to scrutinize processes of the compensation committee. The compensation committee had obtained a report supporting the bonuses from Towers Perrin, a well-regarded compensation consultant, and claimed that it was protected in relying on the report of this expert. However, the compensation consultant who prepared the compensation report on which the compensation committee was relying was initially selected by management, was hired to justify a plan developed by management, had initially criticized the amounts of the bonuses and then only supported them after further meetings with management, and opined in favor of the plan despite being unable to find any comparable transactions. As a result, the Court held that reliance on the compensation report did not provide Jerney with a defense under DGCL § 141(e), which provides that a director will be “fully protected” in relying on experts chosen with reasonable care. The Court explained: “To hold otherwise would replace this court’s role in determining entire fairness under 8 *Del. C.* § 144 with that of various experts hired to give advice.”⁶⁶⁴ The Court also separately examined

that at least two of the committee members were acting in circumstances which raise questions as to their independence from Panic. Tomich and Moses had been close personal friends with Panic for decades. Both were in the process of negotiating with Panic about lucrative consulting deals to follow the completion of their board service. Additionally, Moses, who played a key role in the committee assignment to consider the grant of 5 million options to Panic, had on many separate occasions directly requested stock options for himself from Panic.

⁶⁶¹ In *Julian v. Eastern States Construction Service, Inc.*, C.A. No. 1892-VCP, 2008 WL 2673300, at *1 (Del. Ch. July 8, 2008), the Delaware Chancery Court ordered the disgorgement of director compensation bonuses after its determination that the bonuses did not pass the entire fairness standard and explained:

Self-interested directorial compensation decisions made without independent protections, like other interested transactions, are subject to entire fairness review. Directors of a Delaware corporation who stand on both sides of a transaction have “the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts.” They “are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain.” The two components of entire fairness are fair dealing and fair price. Fair dealing “embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained.” Fair price “assures the transaction was substantively fair by examining ‘the economic and financial considerations.’”

In *Julian*, the Court found it significant that the bonuses were much larger than in prior years (the subject bonus was 22% of adjusted income compared with 3.36% in prior years) and that the bonus reduced the company’s book value at a time when book value was the basis for determining the purchase price for the company’s purchase of the shares of a terminated founder.

⁶⁶² *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983).

⁶⁶³ *Id.* at 711.

⁶⁶⁴ *Valeant*, 921 A.2d at 751.

the consultant's work and concluded that it did not meet the standard for DGCL § 141(e) reliance.

The ICN opinion shows the significant risks that directors face when entire fairness is the standard of review. The opinion also shows the dangers of transactions that confer material benefits on outside directors, thereby resulting in the loss of business judgment rule protection. Although compensation decisions made by independent boards are subject to great deference, that deference disappears when there is not an independent board and entire fairness is the standard. The Court in *Valeant* explained: "Where the self-compensation involves directors or officers paying themselves bonuses, the Court is particularly cognizant to the need for careful scrutiny."⁶⁶⁵

In re Citigroup Inc Shareholder Derivative Litigation. In *In re Citigroup Inc. Shareholder Derivative Litigation*,⁶⁶⁶ claims that the directors were liable to the corporation for waste in approving a multimillion dollar payment and benefit package to Citigroup's CEO upon his retirement survived a motion to dismiss even though the claim of waste under Delaware law required plaintiffs to plead particularized facts that lead to the inference that the directors approved an "exchange that is so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration." The Court noted that there is "an outer limit" to the discretion of the Board in setting compensation, at "which point a decision of the directors on executive compensation is so disproportionately large as to be unconscionable and constitute waste."⁶⁶⁷ If waste is found, it is a non-exculpated violation, as waste constitutes bad faith.

In re The Goldman Sachs Group, Inc Shareholder Litigation. A stockholder challenge to compensation practices at Goldman Sachs was dismissed by Vice Chancellor Glasscock in *In re The Goldman Sachs Group, Inc. Shareholder Litigation*.⁶⁶⁸ The plaintiffs claimed that Goldman's emphasis on net revenues in its compensation policies rewarded employees with bonuses for taking risks but failed to penalize them for losing money; that while Goldman adopted a "pay for performance" philosophy, actual pay practices failed to align stockholder and employee interests; and that the Board should have known that the effect of the compensation practices was to encourage employees to engage in risky or unlawful conduct using corporate assets. In dismissing the claims, the Court commented that "[t]he decision as to how much compensation is appropriate to retain and incentivize employees, both individually and in the aggregate, is a core function of a board of directors exercising its business judgment," and if the shareholders disagree with the Board's judgment, their remedy is to replace directors through "director elections." Recognizing that "it is the essence of business judgment for a board to determine if a particular individual warrants large amounts of money" as payment for services and that even when risk-taking leads to substantial losses, "there should be no finding of waste [for] any other rule would deter corporate boards from the optimal rational acceptance of risk." The Court further recognized that "legal, if risky, actions that are within management's discretion to pursue are not 'red flags' that would put a board on notice of unlawful conduct."

⁶⁶⁵ *Id.* at 745.

⁶⁶⁶ 964 A.2d 106, 139 (Del. Ch. 2009).

⁶⁶⁷ *Id.* at 138.

⁶⁶⁸ C.A. No. 5215-VCG, 2011 Del Ch. LEXIS 151, at *4-5 (Del Ch. Oct. 12, 2011).

The Court further declined to read into *Caremark*⁶⁶⁹ a duty to “monitor business risk” because determining “the trade-off between risk and return” is in essence a business judgment and the courts should not second-guess “a board’s determination of the appropriate amount of risk.”

Freedman v Adams. In *Freedman v. Adams*,⁶⁷⁰ the Delaware Supreme Court considered whether a derivative complaint challenging the decision of the Board of XTO Energy Inc. to pay \$130 million in executive bonuses without adopting a plan qualifying under § 162(m) of the Internal Revenue Code of 1986, as amended (the “*IRC*”), that could make those bonuses tax deductible stated a claim for waste. The XTO Board was aware that bonuses could be made tax deductible under a qualified § 162(m) plan, but concluded that its compensation decisions should be “constrained” by such a plan and disclosed its decision in XTO’s proxy statement. After noting that “[t]o state a claim for waste, a stockholder must allege, with particularity, that the board authorized action that no reasonable person would consider fair,”⁶⁷¹ the Supreme Court held:

The decision to sacrifice some tax savings in order to retain flexibility in compensation decisions is a classic exercise of business judgment. Even if the decision was a poor one for the reasons alleged by Freedman, it was not unconscionable or irrational.

2.6.11. Non-Profit Corporations. The compensation of directors and officers of non-profit corporations can raise conflict of interest issues⁶⁷² comparable to those discussed above in

⁶⁶⁹ See *supra* notes 342-370 and related text.

⁶⁷⁰ 58 A.3d 414, 416 (Del. 2013).

⁶⁷¹ See *supra* notes 340-341.

⁶⁷² TBOC § 22.230 parallels Article 2.30 of the Texas Non-Profit Corporation Act and provides as follows:

Section 22.230. Contracts or Transactions Involving Interested Directors, Officers, and Members.

(a) This section applies only to a contract or transaction between a corporation and:

- (1) one or more of the corporation's directors, officers, or members; or
- (2) an entity or other organization in which one or more of the corporation's directors, officers, or members:
 - (A) is a managerial official or a member; or
 - (B) has a financial interest.

(b) An otherwise valid contract or transaction is valid notwithstanding that a director, officer, or member of the corporation is present at or participates in the meeting of the board of directors, of a committee of the board, or of the members that authorizes the contract or transaction, or votes to authorize the contract or transaction, if:

- (1) the material facts as to the relationship or interest and as to the contract or transaction are disclosed to or known by:
 - (A) the corporation's board of directors, a committee of the board of directors, or the members, and the board, the committee, or the members in good faith and with ordinary care authorize the contract or transaction by the affirmative vote of the majority of the disinterested directors, committee members or members, regardless of whether the disinterested directors, committee members or members constitute a quorum; or

respect of the compensation of directors and officers of for-profit corporations.⁶⁷³ Further, since non-profit corporations often seek to qualify for exemption from federal income taxation under § 501(c)(3) of the Internal Revenue Code of 1986, as amended (the “*IRC*”), as organizations organized and operated exclusively for charitable, religious, literary or scientific purposes and whose earnings do not inure to the benefit of any private shareholders or individuals, the compensation of directors and officers of non-profit corporations can be subject to scrutiny by the Internal Revenue Service (“*IRS*”).⁶⁷⁴ Excessive compensation can be deemed the sort of private inurement that could cause the organization to lose its status as an exempt organization under the IRC and subject the recipient to penalties and other sanctions under the IRC.⁶⁷⁵

(B) the members entitled to vote on the authorization of the contract or transaction, and the contract or transaction is specifically approved in good faith and with ordinary care by a vote of the members; or

(2) the contract or transaction is fair to the corporation when the contract or transaction is authorized, approved, or ratified by the board of directors, a committee of the board of directors, or the members.

(c) Common or interested directors or members of a corporation may be included in determining the presence of a quorum at a meeting of the board, a committee of the board, or members that authorizes the contract or transaction.

⁶⁷³ See, Evelyn Brody, *Principals of the Law of Nonprofit Organizations*, Tentative Draft No. 1 (American Law Institute, Feb. 2007).

⁶⁷⁴ See Report on Exempt Organizations Executive Compensation Compliance Project – Parts I and II, March 2007, http://www.irs.gov/pub/irs-tege/exec_comp_final.pdf.

⁶⁷⁵ See *id.* On February 2, 2007, the IRS issued voluntary guidelines for exempt corporations which are intended to help organizations comply with the requirements for maintaining their tax exempt status under the IRC. In addition to having a Board composed of informed individuals who are active in the oversight of the organization’s operations and finances, the guidelines suggest the following nine specific practices that, taken together, the IRS believes every exempt organization should adopt in order to avoid potential compliance problems:

- Adopt a clearly articulated mission statement that makes manifest its goals and activities.
- Adopt a code of ethics setting ethical standards for legal compliance and integrity.
- The directors exercise that degree of due diligence that allows them to ensure that each such organization’s charitable purpose is being realized in the most efficient manner possible.
- Adopt a conflicts of interest policy and require the filing of a conflicts of interest disclosure form annually by all of its directors.
- Post on its website or otherwise make available to the public all of its tax forms and financial statements.
- Ensure that its fund-raising activities comply fully with all federal and state laws and that the costs of such fund-raising are reasonable.
- Operate in accordance with an annual budget, and, if the organization has substantial assets or revenues, an annual audit should be conducted. Further, the Board should establish an independent audit committee to work with and oversee any outside auditor hired by the organization.
- Pay no more than reasonable compensation for services rendered and generally either not compensate persons for serving on the board of directors or do so only when an appropriate committee composed of persons not compensated by the organization determines to do so.
- Adopt a policy establishing standards for document integrity, retention, and destruction, including guidelines for handling electronic files.

The fiduciary duties of directors applicable to compensation process are comparable to those of a for-profit corporation discussed elsewhere herein.⁶⁷⁶ Like directors of for-profit corporations, directors of non-profit corporations are increasingly subject to scrutiny under fiduciary duty principles with respect to how they handle the compensation of management.

2.6.12. Standards of Judicial Review.

(a) Texas Standard of Review. Possibly because the Texas business judgment rule, as articulated in *Gearhart*, protects so much director action, the parties and the courts in the two leading cases in the takeover context have concentrated on the duty of loyalty in analyzing the propriety of the director conduct.⁶⁷⁷ To prove a breach of the duty of loyalty, it must be shown that the director was “*interested*” in a particular transaction.⁶⁷⁸ In *Copeland*, the Court interpreted *Gearhart* as indicating that “[a]nother means of showing interest, when a threat of takeover is pending, is to demonstrate that actions were taken with the goal of director entrenchment.”⁶⁷⁹

Both the *Gearhart* and *Copeland* Courts assumed that the defendant directors were interested, thus shifting the burden to the directors to prove the fairness of their actions to the corporation.⁶⁸⁰ Once it is shown that a transaction involves an interested director, the transaction is “subject to strict judicial scrutiny but [is] not voidable unless [it is] shown to be unfair to the corporation.”⁶⁸¹ “[T]he burden of proof is on the interested director to show that the action under fire is fair to the corporation.”⁶⁸²

In analyzing the fairness of the transaction at issue, the Fifth Circuit in *Gearhart* relied on the following criteria set forth by Justice Douglas in *Pepper v. Litton*:

See Good Governance Practices for 501(c)(3) Organizations, http://www.irs.gov/pub/irs-tege/governance_practices.pdf.

⁶⁷⁶ TBOC § 22.221 parallels Article 2.26 of the Texas Non-Profit Corporation Act and provides as follows with respect to the duties of directors of a non-profit corporation organized under TBOC:

Section 22.221. General Standards for Directors.

(a) A director shall discharge the director's duties, including duties as a committee member, in good faith, with ordinary care, and in a manner the director reasonably believes to be in the best interest of the corporation.

(b) A director is not liable to the corporation, a member, or another person for an action taken or not taken as a director if the director acted in compliance with this section. A person seeking to establish liability of a director must prove that the director did not act:

(1) in good faith;

(2) with ordinary care; and

(3) in a manner the director reasonably believed to be in the best interest of the corporation.

⁶⁷⁷ See *supra* notes 297-309 and related text.

⁶⁷⁸ See *Gearhart Indus., Inc. v. Smith Int'l, Inc.*, 741 F.2d. 707, 719 (5th Cir. 1984); *A. Copeland Enters., Inc. v. Guste*, 706 F. Supp. 1283, 1290 (W.D. Tex. 1984).

⁶⁷⁹ *Copeland*, 706 F. Supp. at 1290-91.

⁶⁸⁰ See *Gearhart*, 741 F.2d at 722; *Copeland*, 706 F. Supp. at 1291-92.

⁶⁸¹ *Gearhart*, 741 F.2d at 720; see also *Copeland*, 706 F. Supp. at 1291.

⁶⁸² *Gearhart*, 741 F.2d at 720; see also *Copeland*, 706 F. Supp. at 1291.

A director is a fiduciary. So is a dominant or controlling stockholder or group of stockholders. Their powers are powers in trust. Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the director or stockholder not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein. The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain. If it does not, equity will set it aside.⁶⁸³

In *Gearhart*, the Court also stated that a “challenged transaction found to be unfair to the corporate enterprise may nonetheless be upheld if ratified by a majority of disinterested directors or the majority of the stockholders.”⁶⁸⁴

In setting forth the test for fairness, the *Copeland* Court also referred to the criteria discussed in *Pepper v. Litton* and cited *Gearhart* as controlling precedent.⁶⁸⁵ In analyzing the shareholder rights plan (also known as a “*poison pill*”) at issue, however, the Court specifically cited Delaware cases in its after-the-fact analysis of the fairness of the directors’ action.⁶⁸⁶ Whether a Texas court following *Gearhart* would follow Delaware case law in its fairness analysis remains to be seen, especially in light of the Fifth Circuit’s complaint in *Gearhart* that the lawyers focused on Delaware cases and failed to deal with Texas law:

We are both surprised and inconvenienced by the circumstance that, despite their multitudinous and voluminous briefs and exhibits, neither plaintiffs nor defendants seriously attempt to analyze officers’ and directors’ fiduciary duties or the business judgment rule under Texas law. This is particularly so in view of the authorities cited in their discussions of the business judgment rule: Smith and Gearhart argue back and forth over the applicability of the plethora of out-of-state cases they cite, yet they ignore the fact that we are obligated to decide these aspects of this case under Texas law. We note that two cases cited to us as purported Texas authority were both decided under Delaware law. . . .⁶⁸⁷

Given the extent of Delaware case law dealing with director fiduciary duties, it is certain, however, that Delaware cases will be cited and argued by corporate lawyers negotiating transactions and handling any subsequent litigation. The following analysis, therefore, focuses on the pertinent Delaware cases.

(b) Delaware Standard of Review. An examination only of the actual substantive fiduciary duties of corporate directors provides somewhat of an incomplete picture. Compliance with those duties in any particular circumstance will be informed by the standard of review that a court would apply when evaluating a board decision that has been challenged.

⁶⁸³ *Gearhart*, 741 F.2d at 723 (citations omitted) (quoting *Pepper v. Litton*, 308 U.S. 295, 306-07 (1939)).

⁶⁸⁴ *Id.* at 720.

⁶⁸⁵ *See Copeland*, 706 F. Supp. at 1290-91.

⁶⁸⁶ *See id.* at 1291-93.

⁶⁸⁷ *Gearhart*, 741 F.2d at 719 n.4.

Under Delaware law, there are generally three standards against which the courts will measure director conduct. As articulated by the Delaware courts, these standards provide important guidelines for directors and their counsel as to the process to be followed for director action to be sustained. In the context of considering a business combination transaction, these standards are:

- (i) *business judgment rule* – for a decision to remain independent or to approve a transaction not involving a sale of control;
- (ii) *enhanced scrutiny* – for a decision to adopt or employ defensive measures⁶⁸⁸ or to approve a transaction involving a sale of control; and
- (iii) *entire fairness* – for a decision to approve a transaction involving management or a principal shareholder or for any transaction in which a plaintiff successfully rebuts the presumptions of the business judgment rule.

(1) **Business Judgment Rule.** The Delaware business judgment rule “is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”⁶⁸⁹ “A hallmark of the business judgment rule is that a court will not substitute its judgment for that of the board if the latter’s decision can be ‘attributed to any rational business purpose.’”⁶⁹⁰

⁶⁸⁸ In *Williams v. Geier*, 671 A.2d 1368, 1377 (Del. 1996), the Delaware Supreme Court held that an antitakeover defensive measure will not be reviewed under the enhanced scrutiny standard when the defensive measure is approved by stockholders. The Court stated that this standard “should be used only when a board unilaterally (i.e. without stockholder approval) adopts defensive measures in reaction to a perceived threat.” *Id.* at 1377.

⁶⁸⁹ *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984); *see also Brazen v. Bell Atl. Corp.*, 695 A.2d 43, 49 (Del. 1997); *cf.* David Rosenberg, *Galactic Stupidity and the Business Judgment Rule*, 32 J. OF CORP. LAW 301 (2007) (arguing it is wrong for courts to refrain from examining the substantive reasonableness of directors’ decisions in all cases).

⁶⁹⁰ *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) (quoting *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971)); *In re the Dow Chemical Company Derivative Litigation*, No. 4349-CC, 2010 Del. Ch. LEXIS 2, at *1 (Del. Ch. Jan. 11, 2010) (In the context of granting defendants’ motion to dismiss a derivative action filed amid turmoil over Dow’s acquisition of Rohm & Haas that alleged, *inter alia*, that the director defendants breached their fiduciary duties by entering a merger agreement with Rohm & Haas that unconditionally obligated Dow to consummate the merger (“focusing on the substantive provisions of the deal, rather than the procedure employed to make an informed business judgment by a majority of the disinterested and independent board members”), particularly “the board’s decision to enter a merger agreement without a financing condition,” and in rejecting plaintiffs’ argument that the business judgment rule was not applicable to a “bet-the-company” deal, Chancellor Chandler wrote: “Delaware law simply does not support this distinction. A business decision made by a majority of disinterested, independent board members is entitled to the deferential business judgment rule regardless of whether it is an isolated transaction or part of a larger transformative strategy. The interplay among transactions is a decision vested in the board, not the judiciary.”); *see* Stephen M. Bainbridge, *Unocal at 20: Director Primacy in Corporate Takeovers*, 31 DEL. J. CORP. L. 769 (2006); Andrew G.T. Moore II, *The Birth of Unocal—A Brief History*, 31 DEL. J. CORP. L. 865 (2006); A. Gilchrist Sparks III, *A Comment upon “Unocal at 20,”* 31 DEL. J. CORP. L. 887 (2006).

The availability of the business judgment rule does not mean, however, that directors can act on an uninformed basis. Directors must satisfy their duty of care even when they act in the good faith belief that they are acting only in the interests of the corporation and its stockholders. Their decision must be an informed one. “The determination of whether a business judgment is an informed one turns on whether the directors have informed themselves ‘prior to making a business decision, of all material information reasonably available to them.’”⁶⁹¹ In *Van Gorkom*, notwithstanding a transaction price substantially above the current market, directors were held to have been grossly negligent in, among other things, acting in haste without adequately informing themselves as to the value of the corporation.⁶⁹²

(2) Enhanced Scrutiny. When applicable, enhanced scrutiny places on the directors the burden of proving that they have acted reasonably.

The key features of an enhanced scrutiny test are: (a) a judicial determination regarding the adequacy of the decisionmaking process employed by the directors, including the information on which the directors based their decision; and (b) a judicial examination of the reasonableness of the directors’ action in light of the circumstances then existing. The directors have the burden of proving that they were adequately informed and acted reasonably.⁶⁹³

The reasonableness required under enhanced scrutiny falls within a range of acceptable alternatives, which echoes the deference found under the business judgment rule.

[A] court applying enhanced judicial scrutiny should be deciding whether the directors made a reasonable decision, not a perfect decision. If a board selected one of several reasonable alternatives, a court should not second-guess that choice even though it might have decided otherwise or subsequent events may have cast doubt on the board’s determination. Thus, courts will not substitute their business judgment for that of the directors, but will determine if the directors’ decision was, on balance, within a range of reasonableness.⁶⁹⁴

(i) Defensive Measures. In *Unocal Corp. v. Mesa Petroleum Co.*,⁶⁹⁵ the Delaware Supreme Court held that when directors authorize takeover defensive measures, there arises “the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders.”⁶⁹⁶ The Court reviewed such actions with enhanced scrutiny even though a traditional conflict of interest was absent. In refusing to enjoin a selective exchange offer adopted by the board to respond to a hostile takeover attempt, the *Unocal* Court

⁶⁹¹ *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985) (quoting Aronson, 473 A.2d at 812). See generally Bernard S. Sharfman, *Being Informed Does Matter: Fine Tuning Gross Negligence Twenty Plus Years After Van Gorkom*, 62 BUS. LAW. 135 (2006).

⁶⁹² *Van Gorkom*, 488 A.2d at 874.

⁶⁹³ *Paramount Commc’ns Inc. v. QVC Network Inc.*, 637 A.2d 34, 45 (Del. 1994); see also *Quickturn Design Sys., Inc. v. Shapiro*, 721 A.2d 1281, 1290 (Del. 1998).

⁶⁹⁴ *QVC*, 637 A.2d at 45 (emphasis omitted).

⁶⁹⁵ 493 A.2d 946, 954 (Del. 1985).

⁶⁹⁶ *Id.* at 954.

held that the directors must prove that (i) they had reasonable grounds for believing there was a danger to corporate policy and effectiveness (satisfied by showing good faith and reasonable investigation)⁶⁹⁷ and (ii) the responsive action taken was “reasonable in relation to the threat posed” (established by showing that the response to the threat was not “coercive” or “preclusive” and then by demonstrating that the response was within a “range of reasonable responses” to the threat perceived).⁶⁹⁸

In *Gantler v. Stephens*, the Delaware Supreme Court held that *Unocal* did not apply to the rejection of a merger proposal in favor of a going private reclassification in which the certificate of incorporation was amended to convert common stock held by persons owning less than 300 shares into non-voting preferred stock because the reclassification was not a defensive action.⁶⁹⁹

(ii) Sale of Control. In *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,⁷⁰⁰ the Delaware Supreme Court imposed an affirmative duty on the Board to seek the highest value reasonably obtainable to the stockholders when a sale of the company becomes inevitable.⁷⁰¹

⁶⁹⁷ *Id.* at 954-55.

⁶⁹⁸ *Id.* at 955; *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1387-88 (Del. 1995).

⁶⁹⁹ 965 A.2d 695, 705 (Del. 2009).

⁷⁰⁰ 506 A.2d 173, 184 n.16 (Del. 1986).

⁷⁰¹ *See id.* at 182. While *Revlon* placed paramount importance on directors’ duty to seek the highest sale price once their corporation is on the block, simply pointing to a reduced purchase price because of contingent liabilities is not enough to trigger heightened scrutiny of the directors’ actions during the sale process. In *Globis Partners, L.P. v. Plumtree Software, Inc.*, the Court of Chancery dismissed at the pleading stage claims that directors failed to fulfill their duties under *Revlon* because the purchase price negotiations were complicated when the Plumtree board learned that target was in breach of a contract with the U.S. General Services Administration (the “*GSA contract*”), and that a significant liability would likely result from the breach. C.A. No. 1577-VCP, 2007 WL 4292024, at *1-2, *14 (Del. Ch. Nov. 30, 2007). Accordingly, target lowered its selling price in order to induce buyer to proceed with the purchase. *Id.* at *2.

After the merger was announced, plaintiff sued target and its directors derivatively, claiming that the directors breached their fiduciary duties in agreeing to the lower sales price in order to avoid personal liability in connection with the breached GSA contract and additional personal benefits from the merger. *Id.* at *3. In dismissing the complaint, the Court first summarized the bedrock principles of Delaware corporate law relating to directors’ fiduciary duties:

- Directors owe a duty of “unremitting loyalty” to shareholders, and in particular, when the board has determined to sell the company for cash or engage in a change of control transaction, it must, under *Revlon*, “act reasonably in order to secure the highest price reasonably available”;
- In making their decisions, however, directors enjoy the protection of the “business judgment rule” – the “presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company”; and
- If a “proper” decision-making process is followed by the directors, a court will not review the wisdom of the decision itself; the plaintiff must *plead* facts challenging the directors’ decision making in order to rebut the business judgment rule’s presumption.

Id. at *4. As to the allegations that directors approved the merger at a sub-optimal price to avoid derivative liability, the Court held that the plaintiff must plead facts showing: (i) that the directors faced substantial liability; (ii) that the directors were motivated by such liability; and (iii) that the merger was pretextual. *Id.* at *6 (citing *Lewis v. Ward*, 852 A.2d 896, 906 (Del. 2004)). The Court chided the plaintiff for failing to even identify which fiduciary duty the directors might have breached in connection with the GSA contract,

Then in *Paramount Communications Inc. v. QVC Network Inc.*,⁷⁰² when the issues were whether a poison pill could be used selectively to favor one of two competing bidders (effectively precluding shareholders from accepting a tender offer) and whether provisions of the merger agreement (a “no-shop” clause, a “lock-up” stock option, and a break-up fee) were appropriate measures in the face of competing bids for the corporation, the Delaware Supreme Court sweepingly explained the possible extent of enhanced scrutiny:

The consequences of a sale of control impose special obligations on the directors of a corporation. In particular, they have the obligation of acting reasonably to seek the transaction offering the best value reasonably available to the stockholders. The courts will apply enhanced scrutiny to ensure that the directors have acted reasonably.⁷⁰³

The rule announced in *QVC* places a burden on the directors to obtain the *best value reasonably available* once the Board determines to sell the corporation in a change of control transaction. This burden entails more than obtaining a fair price for the shareholders, one within the range of fairness that is commonly opined upon by investment banking firms. In *Cede & Co. v. Technicolor, Inc.*,⁷⁰⁴ the Delaware Supreme Court found a breach of duty even though the transaction price exceeded the value of the corporation determined under the Delaware appraisal statute: “[I]n the review of a transaction involving a sale of a company, the directors have the burden of establishing that the price offered was the highest value reasonably available under the circumstances.”⁷⁰⁵ A merger may be sustained even if it affords modest employment packages for two directors, but a merger price so low that there is nothing left for the common shareholders.⁷⁰⁶

and for failing to plead any facts at all suggesting that any board member took (or failed to take) any direct action with respect to the GSA contract. *See id.* As to whether the directors faced substantial liability due to the problems with the GSA contract, the Court analyzed it as a *Caremark* “duty of oversight” claim which failed because the plaintiff did not allege “either that [target] had no system of controls that would have prevented the GSA overcharges or that there was sustained or systemic failure of the board to exercise oversight.” *See supra* notes 343-353 and related text. Turning to the last two prongs of the analysis, the Court concluded that because the merger negotiations were well underway before the Board became aware of the GSA contract breach, it was unlikely that the merger was motivated by this liability, or was a pretext without a valid business purpose. *Id.* at *7-8.

As to the second possibility, while the Court acknowledged that there was no “bright-line rule” for determining when merger-related benefits compromise a director’s loyalty, it found list of supposed benefits to the directors and determined that they were either immaterial (in the case of the directors’ indemnification rights and the CEO director’s severance), untainted by conflicts of interest (acceleration of options, the value of which would increase as the purchase price rose) or shared by all shareholders (option cash-outs). *See id.* at *8-9.

⁷⁰² 637 A.2d 34, 36 (Del. 1994).

⁷⁰³ *Id.* at 43 (footnote omitted).

⁷⁰⁴ 634 A.2d 345, 361 (Del. 1993).

⁷⁰⁵ *Id.* at 361.

⁷⁰⁶ In *Morgan v. Cash*, C.A. No. 5053-VCS, 2010 WL 2803746, at *1 (Del. Ch. July 16, 2010), a former common shareholder of Voyence, Inc. sued EMC Corporation (the acquirer of Voyence) for aiding and abetting alleged breaches of fiduciary duties by the former Voyence Board and also sued the Board for breaching its fiduciary duties. Because none of the consideration from the sale was distributed to Voyence’s common shareholders, plaintiff argued that EMC was complicit in the Board’s failure to

Although *QVC* mandates enhanced scrutiny of Board action involving a sale of control, a stock for stock merger is considered not to involve a change in control where “when ‘[c]ontrol of both [corporations] remain[s] in a large, fluid, changeable and changing market’”⁷⁰⁷ as continuing shareholders in the target, the former acquired company shareholders retain the opportunity to receive a control premium.⁷⁰⁸ In *QVC* a single person would have had control of the resulting corporation, effectively eliminating the opportunity for shareholders to realize a control premium.⁷⁰⁹

In *Lyondell Chemical Company v. Ryan*,⁷¹⁰ the Delaware Supreme Court, in an *en banc* decision reversing a Chancery Court decision, rejected post-merger stockholder class action claims that independent directors failed to act in good faith in selling the company after only a week of negotiations with a single bidder, even accepting plaintiff’s allegations that the directors did nothing to prepare for an offer which might be expected from a recent purchaser of an 8% block and did not even consider conducting a market check before entering into a merger agreement (at a “blow-out” premium price) containing a no-shop provision (with a fiduciary out) and a 3% break-up fee.⁷¹¹ In *Lyondell* the plaintiff alleged that the defendant directors failed to act in good faith in conducting the sale of Lyondell to an unaffiliated third party, which would have precluded exculpation under Lyondell’s DGCL § 102(b)(7) charter provision and left the

maximize stockholder value in the sale of the Voyence. In granting EMC’s motion to be dismissed from the shareholder litigation. The Court determined that allegations of modest employment packages offered to two directors, standing alone, did not suggest that the Voyence board accepted a low merger price in exchange for improper personal benefits, and the fact that Voyence directors received consideration from the sale of the corporation, and common shareholders did not, was not enough to sustain a claim of collusion between EMC and the Voyence directors. The Court stressed that “[i]t is not a status crime under Delaware law to buy an entity for a price that does not result in a payment to the selling entity’s common stockholders.”

⁷⁰⁷ *Arnold v. Society for Savings Bancorp, Inc.*, 650 A.2d 1270, 1290 (Del. 1994) (quoting *Paramount Commc’ns Inc. v. QVC Network Inc.*, 637 A.2d 34, 42-43, 47 (Del. 1994)); see *In re Synthes, Inc. S’holder Litig.*, 50 A.3d 1022, 1047 (Del. Ch. 2012), in which plaintiff argued that *Revlon* rather than the business judgment rule applied because the merger was an “end stage” transaction in which Synthes’ shareholders were receiving mixed consideration of 65% J&J stock and 35% cash for their Synthes stock, and that this blended consideration represented the last chance they have to get a premium for their Synthes shares; but following *QVC* and its progeny, the Court held that

“*Revlon* duties only apply when a corporation undertakes a transaction that results in the sale or change of control. * * * A change of control ‘does not occur for purposes of *Revlon* where control of the corporation remains, post-merger, in a large, fluid market.’ Here, the Merger consideration consists of a mix of 65% stock and 35% cash, with the stock portion being stock in a company whose shares are held in large, fluid market. In the case of *In re Santa Fe Pacific Corp. Shareholder Litigation*, 669 A.2d 59, 71 (Del. 1995), the Supreme Court held that a merger transaction involving nearly equivalent consideration of 33% cash and 67% stock did not trigger *Revlon* review when there was no basis to infer that the stock portion of that consideration was stock in a controlled company.”

⁷⁰⁸ *Id.*

⁷⁰⁹ *Id.*; see also *Paramount Commc’ns, Inc. v. Time, Inc.*, 571 A.2d 1140, 1150 (Del. 1989).

⁷¹⁰ 970 A.2d 235, 237 (Del. 2009).

⁷¹¹ *Ryan v. Lyondell Chem. Co.*, C.A. No. 3176-VCN, 2008 WL 2923427 (Del. Ch. July 29, 2008) *rev’d* by 970 A.2d 235 (Del. 2009) (“*Lyondell II*”); see J. Travis Laster and Steven M. Haas, *Reactions and Overreactions to Ryan v. Lyondell Chemical Co.*, 22 INSIGHTS No. 9, 9 (Sept. 2008).

directors exposed to personal liability (and possible monetary damages) for their conduct.⁷¹² In *Lyondell* ten of eleven directors were disinterested and independent (the CEO was the other director).

In reversing and holding that summary judgment for the defendant directors should have been granted, the Delaware Supreme Court explained the interplay between the duty of care, the *Revlon* duty to maximize shareholder values and bad faith (for which DGCL § 102(b)(7) exculpation of director liability is not available) as follows:

There is only one *Revlon* duty — to “[get] the best price for the stockholders at a sale of the company.” No court can tell directors exactly how to accomplish that goal, because they will be facing a unique combination of circumstances, many of which will be outside their control. As we noted in *Barkan v. Amsted Industries, Inc.*, “there is no single blueprint that a board must follow to fulfill its duties.” That said, our courts have highlighted both the positive and negative aspects of various boards’ conduct under *Revlon*. The trial court drew several principles from those cases: directors must “engage actively in the sale process,” and they must confirm that they have obtained the best available price either by conducting an auction, by conducting a market check, or by demonstrating “an impeccable knowledge of the market.”

The *Lyondell* directors did not conduct an auction or a market check, and they did not satisfy the trial court that they had the “impeccable” market knowledge that the court believed was necessary to excuse their failure to pursue one of the first two alternatives. As a result, the Court of Chancery was unable to conclude that the directors had met their burden under *Revlon*. In evaluating the totality of the circumstances, even on this limited record, we would be inclined to hold otherwise. But we would not question the trial court’s decision to seek additional evidence if the issue were whether the directors had exercised due care. Where, as here, the issue is whether the directors failed to act in good faith, the analysis is very different, and the existing record mandates the entry of judgment in favor of the directors.

As discussed above, bad faith will be found if a “fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.” The trial court decided that the *Revlon* sale process must follow one of three courses, and that the *Lyondell* directors did not discharge that “known set of [*Revlon*] ‘duties’.” But, as noted, there are no legally prescribed steps that directors must follow to satisfy their *Revlon* duties. Thus, the directors’ failure to take any specific steps during the sale process could not have demonstrated a conscious disregard of their duties. More importantly, there is a vast difference between an inadequate or flawed effort to carry out fiduciary duties and a conscious disregard for those duties.

⁷¹² See *supra* notes 324-339 and related text.

Directors' decisions must be reasonable, not perfect. "In the transactional context, [an] extreme set of facts [is] required to sustain a disloyalty claim premised on the notion that disinterested directors were intentionally disregarding their duties." The trial court denied summary judgment because the Lyondell directors' "unexplained inaction" prevented the court from determining that they had acted in good faith. But, if the directors failed to do all that they should have under the circumstances, they breached their duty of care. Only if they knowingly and completely failed to undertake their responsibilities would they breach their duty of loyalty. The trial court approached the record from the wrong perspective. Instead of questioning whether disinterested, independent directors did everything that they (arguably) should have done to obtain the best sale price, the inquiry should have been whether those directors utterly failed to attempt to obtain the best sale price.

Viewing the record in this manner leads to only one possible conclusion. The Lyondell directors met several times to consider Basell's premium offer. They were generally aware of the value of their company and they knew the chemical company market. The directors solicited and followed the advice of their financial and legal advisors. They attempted to negotiate a higher offer even though all the evidence indicates that Basell had offered a "blowout" price. Finally, they approved the merger agreement, because "it was simply too good not to pass along [to the stockholders] for their consideration." We assume, as we must on summary judgment, that the Lyondell directors did absolutely nothing to prepare for Basell's offer, and that they did not even consider conducting a market check before agreeing to the merger. Even so, this record clearly establishes that the Lyondell directors did not breach their duty of loyalty by failing to act in good faith. In concluding otherwise, the Court of Chancery reversibly erred.⁷¹³

The Delaware Supreme Court's opinion should be read in its context of an opinion on a denial of a motion for summary judgment on post-merger damage claims where there were some uncontested facts in the record before the court (rather than a motion to dismiss where the facts alleged in plaintiff's pleadings must be accepted as true). The opinion should also be read as a strong statement that the Delaware courts will give deference to the decision of disinterested and independent directors when faced with a perceived need to act quickly on a proposal from an unaffiliated, serious bidder that reasonably appears to the directors to be in the best interests of the stockholders. More specific lessons from the opinion are:

- *Revlon* duties do not arise until the Board starts a negotiation to sell the company and do not arise simply because the Board has facts that give the Board reason to believe that a third party will make an acquisition proposal. In the Supreme Court's words: "Revlon duties do not arise simply because a company is 'in play.' The duty to seek the best available price applies only when a company embarks on a transaction . . . that will result in a change of control."⁷¹⁴ *Revlon* does not require a Board to obtain a valuation of the company, commence an auction or implement defensive measures just because the

⁷¹³ *Lyondell II*, 970 A.2d at 235, 242-44.

⁷¹⁴ *Id.* at 242.

company is “in play.” A Board can exercise its business judgment to “wait and see” when a Schedule 13D has been filed that suggests a bid for the company is reasonably to be expected.

- When the *Revlon* duties become applicable, there is no single blueprint that a Board must follow to satisfy its *Revlon* duties. In the words of the Delaware Supreme Court: no “court can tell directors exactly how to accomplish [the *Revlon* goal to get the best price for the company], because they will be facing a unique combination of circumstances.”⁷¹⁵ Because there are no mandated steps, directors’ failure to take any specific steps cannot amount to the conscious disregard of duties required for a finding of bad faith.
- Since there are no specific steps a Board must take to satisfy its *Revlon* duties, directors do not fail in their duty of good faith to the shareholders if they do not seek competing bids, when they have a fairness opinion and reason to believe that no topping bid is likely, and instead try (albeit unsuccessfully) to extract a higher price from the bidder. The directors do not have to succeed in negotiating a post-signing market check. Rather, the Delaware Supreme Court said directors fail in their duty of good faith: “Only if [the directors] knowingly and completely failed to undertake their responsibilities would they breach their duty of loyalty. * * * Instead of questioning whether disinterested, independent directors did everything that they (arguably) should have done to obtain the best sale price, the [Chancery Court’s] inquiry should have been whether those directors utterly failed to attempt to obtain the best sale price.”⁷¹⁶ While a flawed process may be enough for a breach of the duty of care, it is not enough to establish the “conscious disregard” of known fiduciary duties required for a lack of good faith. The Delaware Supreme Court’s opinion does not measure the directors’ conduct on a duty of care scale, although the Supreme Court did comment that it “would not question the trial court’s decision to seek additional evidence if the issue were whether the directors had exercised due care.”⁷¹⁷
- Directors do not breach their duty of good faith by agreeing to reasonable deal protection provisions in the absence of an auction.
- Concluding merger negotiations in a one week period is not bad faith.

In *Steinhardt v. Howard-Anderson*,⁷¹⁸ the Court suggested that *Revlon* should be applicable to an all stock merger where the acquired company shareholders would be the minority in the post-merger corporation and the focus would be whether the process was adequate to compensate for an appropriate control premium for the target. In so ruling, the Vice Chancellor stated, “This is a situation where the target stockholders are in the end stage in terms of their interest in [the target].... This is the only chance that [the target] stockholders have to extract a premium, both in the sense of maximizing cash now, and in the sense of maximizing their relative share of the future entity’s control premium.”

⁷¹⁵ *Id.*

⁷¹⁶ *Id.* at 244.

⁷¹⁷ *Id.* at 243.

⁷¹⁸ C.A. No. 5878-VCL, 2012 Del. Ch. LEXIS 1, at *2 (Del. Ch. Jan. 6, 2012).

In *In re Smurfit-Stone Container Corp. Shareholder Litigation*,⁷¹⁹ the Court ruled that *Revlon* would likely apply to half-cash, half-stock mergers, reasoning that enhanced judicial scrutiny was in order because a significant portion “of the stockholders’ investment . . . will be converted to cash and thereby deprived of its long-run potential,” although he noted that the issue remains unresolved by the Delaware Supreme Court, and that the “conclusion that *Revlon* applies [to a mixed-consideration merger] is not free from doubt.”

In *C&J Energy Services, Inc. v. City of Miami General Employees’ and Sanitation Employees’ Retirement Trust*,⁷²⁰ the Delaware Supreme Court held that the *Revlon* duty to design a process with a view to obtaining the best value reasonably available to the stockholders, but does not require the Board to auction the company. The court explained:

Revlon involved a decision by a board of directors to chill the emergence of a higher offer from a bidder because the board’s CEO disliked the new bidder, after the target board had agreed to sell the company for cash. *Revlon* made clear that when a board engages in a change of control transaction, it must not take actions inconsistent with achieving the highest immediate value reasonably attainable.

But *Revlon* does not require a board to set aside its own view of what is best for the corporation’s stockholders and run an auction whenever the board approves a change of control transaction. As this Court has made clear, “there is no single blueprint that a board must follow to fulfill its duties,” and a court applying *Revlon*’s enhanced scrutiny must decide “whether the directors made a *reasonable* decision, not a *perfect* decision.”

In a series of decisions in the wake of *Revlon*, Chancellor Allen correctly read its holding as permitting a board to pursue the transaction it reasonably views as most valuable to stockholders, so long as the transaction is subject to an effective market check under circumstances in which any bidder interested in paying more has a reasonable opportunity to do so. Such a market check does not have to involve an active solicitation, so long as interested bidders have a fair opportunity to present a higher-value alternative, and the board has the flexibility to eschew the original transaction and accept the higher-value deal. The ability of the stockholders themselves to freely accept or reject the board’s preferred course of action is also of great importance in this context.

A controlling stockholder is generally permitted to negotiate a control premium and act without regard to the minority in doing so.⁷²¹ Where, however, the holder of a class of stock with ten votes per share had capped his voting power at 49.9% by a charter provision agreed to in connection with a public offering, the controlling stockholder was found in *In re Delphi*

⁷¹⁹ *In re Smurfit-Stone Container Corp. S’holder Litig.*, C.A. No. 6164-VCP, 2011 Del. Ch. LEXIS 79, at *2 (Del. Ch. May 20, 2011).

⁷²⁰ 107 A.3d 1049 (Del. 2014).

⁷²¹ *In re Delphi Financial Group Shareholder Litigation*, C.A. No. 7144-VCG, 2012 Del. Ch. LEXIS 45, at *3 (Del. Ch. Mar. 6, 2012), available at <http://courts.delaware.gov/opinions/download.aspx?ID=169430>.

Financial Group Shareholder Litigation to have sold his right to demand a premium and violated both his contractual and fiduciary duties by insisting on a premium.⁷²²

(3) Entire Fairness. Both the business judgment rule and the enhanced scrutiny standard should be contrasted with the “*entire fairness*” standard applied in transactions in which a controlling stockholder (a “*controller*”) stands on both sides of the transaction.⁷²³ In reviewing Board action in transactions involving management, Board members or a principal shareholder, the Delaware Supreme Court has imposed an “entire fairness” standard.⁷²⁴ While a stockholder owning a majority of a corporation’s stock will typically be found to be a controller, a stockholder owning less than 50% of the voting stock may be a controller if its stock ownership combined with other factors allows it to dominate the governance of the corporation.⁷²⁵

⁷²² *Id.*

⁷²³ Directors also will have the burden to prove the entire fairness of the transaction to the corporation and its stockholders if a stockholder plaintiff successfully rebuts the presumption of valid business judgment. See *Aronson v. Lewis*, 473 A.2d 805, 811-12 (Del. 1984).

⁷²⁴ See *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710-11 (Del. 1983); see also *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1264-65 (Del. 1988) (applying the standard set forth in *Weinberger*).

⁷²⁵ See *In Re Zhongpin Inc. Consolidated Stockholders Litigation*, No. 7393-VCN (Del. Ch. Nov. 26, 2014) (Chancery Court denied a motion to dismiss brought against the individual members of the Board of a Chinese company because plaintiffs had sufficiently alleged that the CEO was a de facto controlling shareholder despite his holding a mere 17.3% of the company’s stock because of his influence over major company decisions, as well his continuing insistence on a price was below the even the low end of the valuation ranges); *In re Sanchez Energy Derivative Litigation*, Consol. C.A. No. 9132-VCG, 2014 WL 6673895 (Del. Ch. Nov. 25, 2014) (Two directors collectively owned 21.5% of Sanchez Energy and one of the directors was the president and CEO of Sanchez Energy and president of another company that provided management services to Sanchez Energy; plaintiffs alleged those two directors were controlling stockholders of Sanchez Energy; the court held such allegations did not support a reasonable inference that the two directors were controlling stockholders because they did not sufficiently allege that the two directors exercised “actual control” over the Sanchez Energy Board.); *In re Crimson Exploration Inc. Stockholder Litigation*, No. CV 8541-VCP, 2014 WL 5449419 (Del. Ch. Oct. 24, 2014) (Chancery Court held that for large stockholders who held less than 50% of the outstanding capital stock of the target company, the factual analysis for determining the judicial standard of review turns on whether the stockholder “actually control[s] the Board’s decisions about the challenged transaction,” and whether the stockholder actually “dominated” the Board. In addition, the court will review whether the stockholder will receive a special benefit in the transaction separate and apart from what other stockholders will receive. In this case, the court found that the mere fact that the stockholder held over 30% of the target company’s capital stock and had designated a majority of the Board and executive officers of the target company did not result in the stockholder actually controlling the Board’s decisions with respect to the contemplated transaction; the fact that the large stockholder was also a large creditor and would receive a relatively modest debt pre-payment penalty and registration rights in the transaction was not viewed as sufficiently “unique benefits” to change the analysis); *In re KKR Financial Holdings LLC Shareholder Litigation*, 101 A.3d 980, 991, 993-94 (Del. Ch. Oct. 14, 2014) (applying the touchstone of “actual control,” Chancery Court held that, although the stockholder which held less than 1% of the corporation’s stock exercised total managerial control pursuant to a management agreement between the target and an affiliate of the stockholder, that control was only contractual operating control and ultimate control over the transaction resided with the target company’s Board, which the stockholder did not control through the management agreement); *In re Morton’s Rest. Grp., Inc. S’holders Litig.*, 74 A.3d 656, 658 (Del. Ch. 2013) (mem. op.). (In rejecting the plaintiff’s “attempt to enjoin a tender offer and second-step merger between a corporation and an arm’s-length purchaser,” Chancellor Strine wrote that plaintiffs “point to no authority under Delaware law that a stockholder with only a 27.7% block and whose employees comprise only two out of ten board seats creates a rational inference that it was a controlling stockholder. * * * When a stockholder

In *Kahn v. Lynch Communication Systems, Inc.* (“*Lynch I*”)⁷²⁶ the Delaware Supreme Court held “that the exclusive standard of judicial review in examining the propriety of an interested cash-out merger transaction by a controlling or dominating shareholder is entire fairness” and that “[t]he initial burden of establishing entire fairness rests upon the party who stands on both sides of the transaction.”⁷²⁷ Additionally, “approval of the transaction by an independent committee of directors or an informed majority of minority shareholders” would shift the burden of proof on the issue of fairness to the plaintiff, but would not change that entire fairness was the standard of review.⁷²⁸

The entire fairness standard was applied to a transaction in which a controlling stockholder was only on one side of the transaction. *In re John Q. Hammons Hotels Inc. S’holder Litig.*⁷²⁹ involved a transaction in which a corporation with a controlling stockholder (who owned 5% of the company’s Class A shares and 100% of its Class B shares, which gave him 76% of the total voting power) was purchased by an unaffiliated third-party acquirer. A special committee negotiated the transaction on behalf of the minority public stockholders. There was a majority-of-the-minority-voting provision, which was waivable (but not waived) by the special committee. All of the Class A stockholders received the same cash purchase price, and the controlling stockholder received separate consideration for his Class B shares, including a line of credit and a small continuing interest in the surviving entity (to avoid certain tax implications), that was valued by the special committee’s financial advisor at far less than price paid to the Class A stockholders. Plaintiffs alleged that the controlling stockholder breached his fiduciary duties as such by negotiating benefits for himself that were not shared with the minority stockholders. Plaintiffs contended that the directors breached their fiduciary duties by

owns less than 50% of the corporation’s outstanding stock, ‘a plaintiff must allege domination by a minority shareholder through actual control of corporate conduct.’ The bare conclusory allegation that a minority stockholder possessed control is insufficient. Rather, the Complaint must contain well-pled facts showing that the minority stockholder ‘exercised actual domination and control over ... [the] directors.’ That is, under our law, a minority blockholder is not considered to be a controlling stockholder unless it exercises ‘such formidable voting and managerial power that [it], as a practical matter, [is] no differently situated than if [it] had majority voting control.’ Accordingly, the minority blockholder’s power must be ‘so potent that independent directors ... cannot freely exercise their judgment, fearing retribution’ from the controlling minority blockholder.”)

⁷²⁶ 638 A.2d 1110, 1117 (Del. 1994).

⁷²⁷ *Id.* at 1117 (citations omitted). See *In re Cornerstone Therapeutics Inc. S’holder Litig.*, Consol. C.A. No. 8922-VCG, 2014 WL 4418169, at *10 (Del. Ch. Sept. 10, 2014) (In denying a motion to dismiss, the Court of Chancery held that, in a controller transaction governed by entire fairness review, a plaintiff need not specifically plead non-exculpated breaches of duty as to disinterested director defendants in order to withstand a motion to dismiss; rather, the court held, whether director defendants breached a non-exculpated duty was an issue to be addressed only if, after a trial on a fully developed record, the transaction at issue was found to be not entirely fair.).

⁷²⁸ *Id.* A different standard applies to transactions that effectively cash out minority shareholders through a tender offer followed by a short-form merger. See *In re Aquila Inc.*, 805 A.2d 184, 190-91 (Del. Ch. 2002); *In re Siliconix Inc. S’holders Litig.*, C.A. No. 18700, 2001 WL 716787, at *6-9 (Del. Ch. June 19, 2001); see generally *In re Pure Res., Inc. S’holders Litig.*, 808 A.2d 421, 434-39 (Del. Ch. 2002); see also *infra* notes 767-805 and related text.

⁷²⁹ C.A. No. 758-CC, 2009 WL 3165613, at *1 (Del. Ch. Oct. 2, 2009). See Mark A. Morton, Michael K. Reilly and Daniel A. Mason, *In re John Q. Hammons Hotels, Inc.: A New Roadmap for Conflict Transactions?*, Vol. IX Deal Points (The Newsletter of the ABA Business Law Section Committee on Mergers and Acquisitions), Issue 3 (Fall 2009) at 3.

allowing the merger to be negotiated through a deficient process and then voting to approve the merger. Claims for aiding and abetting these breaches of fiduciary duty were asserted against the buyer entities. On cross-motions for summary judgment, the Chancery Court concluded that, although not mandated under *Lynch I* since the controlling stockholder was not on both sides of the transaction, the entire fairness standard of review applied because the controlling stockholder and the minority were “competing” for consideration:

Although I have determined that Hammons [the controlling stockholder] did not stand “on both sides” of this transaction, it is nonetheless true that Hammons and the minority stockholders were in a sense “competing” for portions of the consideration Eilian was willing to pay to acquire JQH and that Hammons, as a result of his controlling position, could effectively veto any transaction. In such a case it is paramount—indeed, necessary in order to invoke business judgment review—that there be robust procedural protections in place to ensure that the minority stockholders have sufficient bargaining power and the ability to make an informed choice of whether to accept the third-party’s offer for their shares.

The Court explained that business judgment review would only apply if the transaction were both (i) approved by a disinterested and independent special committee and (ii) approved by stockholders in a non-waivable vote of the majority of ALL the minority stockholders which would serve as a check on the special committee. Since the majority-of-minority condition was waivable in *Hammons* and was based on those voting and not ALL minority stockholders, entire fairness would apply, even though the condition was not waived and even though a majority of all minority stockholders did approve the transaction.

Under the entire fairness standard the burden is on directors to show both (i) fair dealing and (ii) a fair price:

The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company’s stock.⁷³⁰

The burden shifts to the challenger to show the transaction was unfair where (i) the transaction is approved by the majority of the minority shareholders, though the burden remains on the directors to show that they “completely disclosed all material facts relevant to the transaction,”⁷³¹ or (ii) the transaction is negotiated by a special committee of independent directors that is truly independent, not coerced and has real bargaining power.⁷³²

⁷³⁰ *Weinberger*, 457 A.2d at 711.

⁷³¹ *Id.* at 703.

⁷³² *See Kahn v. Lynch Communications Sys., Inc.*, 638 A.2d 1110, 1117 (Del. 1994).

After a trial which involved dueling valuation expert witnesses, the Court in *John Q. Hammons* concluded that the merger was entirely fair and that defendants were not liable for any breach of fiduciary or aiding and abetting.⁷³³ In finding fair process, the Court found that (i) the special committee was independent and disinterested and that the Board acted in the best interests of the minority stockholders; (ii) the members of the special committee were qualified and experienced in the company's industry; (iii) the special committee understood that it had the authority and duty to reject any offer that was unfair to the minority stockholders; and (iv) the special committee was through, deliberate and negotiated at arms-length over a nine month period with two active bidders. The overwhelming approval of the transaction by the unaffiliated shareholders was also influential. The controlling stockholder's power to reject any offer he did not like was not coercive because rejection would only leave the status quo, which the stockholders accepted when then bought their shares. As to the fair price prong of entire fairness, the Court found the defendants' expert witness more persuasive than plaintiffs' expert witnesses with their "litigation driven projections." The proxy statement's failure to disclose that counsel for the special committee also represented a lender to the winning bidder was found to be immaterial.

In *Kahn v. M&F Worldwide Corp.*,⁷³⁴ the Delaware Supreme Court held that the business judgment rule review can apply to squeeze-out mergers conditioned up front on both approval by a special committee and a majority-of-the-minority vote. The case arose out of a stockholder challenge to a merger in which MacAndrews & Forbes ("M&F") acquired the 57% of M&F Worldwide ("MFW") it did not already own and which was subject to the approval of both an independent special committee and the majority of stockholders unaffiliated with MacAndrews. The merger process commenced with a letter from M&F to the Board of MFW proposing to buy the MFW stock that it did not own for \$24 cash and stating:

It is our expectation that the Board of Directors will appoint a special committee of independent directors to consider our proposal and make a recommendation to the Board of Directors. *We will not move forward with the transaction unless it is approved by such a special committee. In addition, the transaction will be subject to a nonwaivable condition requiring the approval of a majority of the shares of the Company not owned by M&F or its affiliates. . . .*

The independent directors then decided to form a special committee. The Board resolution designating the special committee empowered it as follows:

[T]he Special Committee is empowered to: (i) make such investigation of the Proposal as the Special Committee deems appropriate; (ii) evaluate the terms of the Proposal; (iii) negotiate with [M&F] and its representatives any element of the Proposal; (iv) negotiate the terms of any definitive agreement with respect to the Proposal (it being understood that the execution thereof shall be subject to the approval of the Board); (v) report to the Board its recommendations and conclusions with respect to the Proposal, including a determination and

⁷³³ *In re John Q. Hammons Hotels Inc. S'holder Litig.*, C.A. No. 758-CC, 2011 Del. Ch. LEXIS 1, at *2 (Del. Ch. Jan. 14, 2011).

⁷³⁴ 88 A.3d 635 (Del. 2014).

recommendation as to whether the Proposal is fair and in the best interests of the stockholders of the Company other than Holdings and its affiliates and should be approved by the Board; and (vi) determine to elect not to pursue the Proposal

* * *

. . . [T]he Board shall not approve the Proposal without a prior favorable recommendation of the Special Committee

. . . [T]he Special Committee [is] empowered to retain and employ legal counsel, a financial advisor, and such other agents as the Special Committee shall deem necessary or desirable in connection with these matters

Although the special committee was delegated the authority to negotiate and say no, it did not have the practical authority to market MFW to other buyers. In announcing its proposal to the Board, M&F stated that it was not interested in selling its 43% stake.

A unanimous Delaware Supreme Court sitting *en banc* held that the business judgment rule standard of review applies to squeeze-out mergers with controlling stockholders so long as from the outset of the merger negotiations the controlling stockholder commits to proceed with the merger only if it is subject to both (i) negotiation and approval by a special committee of independent directors free to select its advisors and empowered to say no definitively and that fulfills its duty of care and (ii) approval by an uncoerced, fully informed vote of a majority of the minority. The Supreme Court further indicated that if triable issues of fact remain after discovery about whether either procedural protection was established or effective, then a squeeze-out merger will be subject to entire fairness review at trial.

Noting that the appeal presented a question of first impression, the Delaware Supreme Court held that business judgment review would only apply if all the following elements were present: (1) the controller from the outset conditions the transaction on the approval of both a special committee and a majority of the minority stockholders; (2) the special committee is independent; (3) the special committee is empowered to freely select its own advisors and to say no definitively; (4) the special committee meets its duty of care in negotiating a fair price; (5) the minority vote is informed; and (6) the minority is not coerced.

Distinguishing prior cases involving squeeze-out mergers in which it had held that the most either a well-functioning special committee or an informed majority of the minority stockholder vote could effect was a shifting of the burden to the plaintiffs to prove that the transaction was not entirely fair, a burden-shifting it continued to endorse, the Supreme Court noted the distinguishing characteristic of *In re MFW* was the controller's agreement up front to forgo exercising its voting power on a non-waivable basis, which would limit the potential for any retributive going private effort by the controller. The Supreme Court reasoned that the dual procedural protections optimally protect minority stockholders in squeeze-out mergers because the controller "irrevocably and publicly disables itself" from being able to dictate the outcome of the negotiations and the minority stockholder vote (the minority stockholders are given the ability to decide whether to accept a deal recommended by an independent negotiating agent that cannot be bypassed and that is empowered to bargain for the best price and reject any inadvisable

deal), simulating third-party, arm's-length mergers that are subject to business judgment review in the first instance. Applying the business judgment rule was considered consistent with Delaware law's tradition of deferring to informed decisions of impartial directors approved by uncoerced, fully-informed disinterested stockholders. Finally, the Supreme Court reasoned that so long as plaintiffs can plead a reasonably conceivable set of facts showing that any of the elements needed to obtain the business judgment standard did not exist, the plaintiffs would be entitled to discovery and the issue of fair price in controller buyouts would continue to be subject to pretrial scrutiny because a trial court will only be able to determine if business judgment review applies to a controller buyout after the court has made a pretrial assessment, following discovery, of whether an independent, adequately-empowered special committee that acted with due care achieved a fair price that was approved by an uncoerced, fully-informed majority of the minority.

The Supreme Court confirmed the Chancery Court's findings that the dual procedural prongs had been established and business judgment review properly applied at summary judgment. However, the Supreme Court, in its infamous footnote 14, noted that the plaintiffs' claims would have survived a motion to dismiss under this new standard had such a motion been brought, permitting them to obtain discovery, based on the specific allegations in the plaintiffs' complaint challenging the sufficiency of the merger price that implicated the adequacy of the special committee's negotiations.

A transaction structured to achieve business judgment rule review under *MFW* was subjected to (and failed) entire fairness review in *In re Dole Food. Co. Inc. Stockholder Litigation*⁷³⁵ because the Chancery Court found the transaction complied with *MFW* as to form but not substance because of misleading projections and other information furnished to the special committee. The case arose out of the going private buyout merger in which David H. Murdock acquired the 60% of Dole Food Company, Inc. which he did not already own and in which the Vice Chancellor ordered Mr. Murdock to pay an additional \$148.2 million to Dole shareholders because he found that the merger was not entirely fair. Murdock, a 92-year-old billionaire who took control of Dole in 1985, had already taken the food company private once in 2003. He sold a 41% stake to the public again in 2009 at \$12.50 a share when he was in financial difficulty, but disliking the sharing of control required with a public company and minority shareholders, decided to take Dole private again.

In his initial offer to Dole's Board, Murdock proposed to pay \$12 per share for the minority shares. Structuring his proposal to meet the requirements for business judgment rule (rather than entire fairness) review under the teachings of the *MFW* case, Murdock's offer was conditioned on (i) approval from a special committee of the Board consisting of disinterested and independent directors, who were empowered to and did engage a competent financial adviser (Lazard Freres) and counsel (Sullivan & Cromwell), and (ii) the affirmative vote of a majority of the unaffiliated shares (50.2% of the minority shares voted in favor of the merger). The Vice Chancellor found that while the form of *MFW* was followed and the special committee and its advisers performed their roles with diligence and integrity, having negotiated the merger price from the initially offered \$12 per share to \$13.50 per share, the substance of *MFW* was not satisfied because Murdock and his right-hand man, Dole's President and General Counsel

⁷³⁵ CA No. 8703-VCL (August 27, 2015).

Michael Carter, undermined the Special Committee by concealing favorable information about Dole from the Special Committee. The Vice Chancellor particularly focused defendants' giving lowball projections to the special committee that understated savings Dole could realize after selling approximately half of its business to a joint venture a year before the merger and from purchasing farms to supply products. Further, Carter cancelled a stock repurchase program to push the market price of Dole down to make the going private proposal more attractive and misstated the reasons therefor. The Vice Chancellor wrote "what the Committee could not overcome, what the stockholder vote could not cleanse, and what even an arguably fair price does not immunize, is fraud." Even though the Court found the merger price was within the range of fairness as Lazard had opined, the Court wrote that the stockholders "are entitled to a fairer price designed to eliminate the ability of defendants to profit from their breaches of the duty of loyalty" and awarded them an additional \$2.74 per share (a total of \$148.2 million).

In *In re Morton's Rest. Grp., Inc. S'holders Litig.*,⁷³⁶ the Chancery Court applied the business judgment rule in dismissing a complaint challenging the fairness of a merger because the target's 27.7% stockholder was a private equity fund whose sponsor allegedly had a unique need to sell the target, even at a lowball price, in order to liquidate the fund and sell a new one. In applying the business judgment rule and dismissing the complaint, the Court wrote:

The plaintiffs, former stockholders of Morton's, have attacked the transaction, alleging in their Complaint that Castle Harlan, acting in its own self-interest, caused the board of Morton's to sell the company "quickly," without regard to the long-term interests of the public shareholders. Although the plaintiffs now do not dispute that every likely buyer was contacted, that Castle Harlan [the fund with 27.7% of target's stock] benefited from the transaction pro rata with the other stockholders, that a majority of the board, who were independent and disinterested, approved the transaction following a broad search for buyers in a process lasting nine months, that the winning bidder had no ties to a board member of Morton's [target] or Castle Harlan, that Fertitta [buyer] made the highest binding offer, and that over 90% of the stockholders tendered their shares, the plaintiffs say that despite these facts, the Complaint cannot be dismissed because the transaction is subject to entire fairness review. According to the plaintiffs, the mere presence of a controlling stockholder in a transaction—regardless of whether the controller receives anything different from the other stockholders—triggers entire fairness review. Therefore, in an attempt to sustain their Complaint, the plaintiffs allege, but without the support of particular facts, that Castle Harlan was a controlling stockholder that dominated the company's board of directors.

In addition, the plaintiffs claim that the sale to Fertitta is subject to entire fairness review by suggesting that Castle Harlan had a conflict of interest because it had a unique liquidity need that caused it to push for a sale of Morton's at an inadequate price. The plaintiffs say that the company's eight directors unaffiliated with Castle Harlan acquiesced in Castle Harlan's plan and approved a lowball transaction because they were willing to put the liquidity needs of the

⁷³⁶ 74 A.3d 656, 660 (Del. Ch. 2013).

company's controller, Castle Harlan, above their fiduciary duties to the stockholders of Morton's. As such, the plaintiffs claim that the board breached their fiduciary duty of loyalty. The Complaint further alleges that the buyer (Fertitta) and the company's two financial advisors (Jefferies and KeyBanc) conspired with the board and Castle Harlan to sell Morton's cheaply, and thus aided and abetted the board's breach of fiduciary duty.

But the plaintiffs' attempt to invoke entire fairness scrutiny fails on two levels. First, they point to no authority under Delaware law that a stockholder with only a 27.7% block and whose employees comprise only two out of ten board seats creates a rational inference that it was a controlling stockholder. Under our Supreme Court precedent in decisions like *Kahn v. Lynch Communication Systems*, the plaintiffs' allegations fall short of creating a rational inference that Castle Harlan had effective control of Morton's, and thus was a controlling stockholder, especially where the Complaint does not even attempt to cast into doubt the independence of the seven disinterested directors from the alleged controller.

Second, even if Castle Harlan could be considered a controlling stockholder, the plaintiffs have failed to make any well-pled allegations indicating that Castle Harlan had a conflict of interest with the other stockholders of Morton's. That is, the plaintiffs plead no facts supporting a rational inference that it is conceivable that Castle Harlan's support for an extended market check involving an approach to over 100 bidders in a nine-month process reflected a crisis need for a fire sale. As is recognized by decisions like *Unitrin, Inc. v. American General Corp.*, Delaware law presumes that large shareholders have strong incentives to maximize the value of their shares in a change of control transaction. When a large stockholder supports an arm's-length transaction resulting from a thorough market check that spreads the transactional consideration ratably across all stockholders, Delaware law does not regard that as a conflict transaction. To the contrary, as cases like *Citron v. Fairchild Camera and Instrument Corp.* and *In re Synthes* point out, such conduct presumptively considers equal treatment as a safe harbor and immunizes the transaction because it allows all the stockholders to share in the benefits of a transaction equally with the large blockholder.

Because the Complaint does not plead any facts supporting a rational inference of a conflict of interest on Castle Harlan's or on any board member's part, the Complaint fails to plead a viable damages claim. Given that Morton's has an exculpatory charter provision, the plaintiffs must plead a non-exculpated claim that the directors of Morton's breached their duties under *Revlon*. Because the Complaint fails to plead any rational motive for the directors to do anything other than attempt to maximize the sale value of Morton's, it fails. In this regard, the plaintiffs face the reality that under *Revlon*, the duty of the board was to take a reasonable course of action to ensure that the highest value reasonably attainable was secured. When in the course of the pleading stage, the plaintiffs concede that a board reaches out to over 100 buyers, signs up over 50 confidentiality

agreements, treats all bidders evenhandedly, and employs two qualified investment banks to help test the market, they provide no basis for the court to infer that there was any *Revlon* breach, much less a non-exculpated one, under our Supreme Court precedent in cases like *Lyondell Chemical Co. v. Ryan*. Likewise, the plaintiffs' quibbles over the investment bankers' analyses the plaintiffs disagree with provide no basis for inferring a *Revlon* breach of any kind, and certainly no basis to question why a board of directors would recommend a premium-generating transaction that came after such a thorough market check.

The Court also rejected claims that the Board acted in bad faith in allowing its financial adviser to provide buy side financing where (i) the financial adviser's request was made to Board on the basis that buyer was having difficulty arranging financing, (ii) the adviser recused itself from further negotiations, (iii) reduced its fee, (iv) would still opine on whether the resulting transaction was fair once the terms were set, and (iv) the Board used the reduced fee to hire another advisor who further tested the market and rendered its fairness opinion. The Court also rejected allegations that the deal protection devices were unreasonable, commenting:

[T]he modest deal protections contained in the Merger Agreement could not be conceived of as, in any way, preclusive or coercive for two distinct and important reasons. First, they could not have precluded any serious buyer, given that the company's strategic search was so broad that all plausible buyers had a chance to bid for Morton's without facing the inhibiting effect of deal protections at all. * * * Second, the 3% termination fee, the no solicitation provision with a fiduciary out, the matching rights, and the top-up provision awarded to the top bidder of a lengthy sale process, could not be considered unreasonable or a serious deterrent to any bidder wishing to make a genuinely more valuable topping bid.

(c) Action Without Bright Lines. Whether the burden will be on the party challenging Board action, under the business judgment rule, or on the directors, under enhanced scrutiny, clearly the care with which the directors acted in a change of control transaction will be subjected to close review. For this review there will be no "bright line" tests, and it may be assumed that the board may be called upon to show care commensurate with the importance of the decisions made, whatever they may have been in the circumstances. Thus directors, and counsel advising them, should heed the Delaware Supreme Court in *Barkan v. Amsted Industries, Inc.*: "[T]here is no single blueprint that a board must follow to fulfill its duties. A stereotypical approach to the sale and acquisition of corporate control is not to be expected in the face of the evolving techniques and financing devices employed in today's corporate environment."⁷³⁷ In the absence of bright lines and blueprints that fit all cases, the process to be followed by the directors will be paramount. The elements of the process should be clearly understood at the beginning, and the process should be guided and well documented by counsel throughout.

2.7. Board Responsibilities in Business Combination Transactions.

2.7.1. Management's Immediate Response. Serious proposals for a business combination require serious consideration. The CEO and management will usually be called upon to make an initial judgment as to seriousness. A written, well developed proposal from a credible

⁷³⁷ 567 A.2d 1279, 1286 (Del. 1989) (citing *Mills Acquisition Co.*, 559 A.2d at 1286-88).

prospective acquiror should be studied. In contrast, an oral proposal, or a written one that is incomplete in material respects, should not require management efforts to develop the proposal further. In no event need management's response indicate any willingness to be acquired. In *Citron v. Fairchild Camera and Instrument Corp.*,⁷³⁸ for example, the Delaware Supreme Court sanctioned behavior that included the CEO's informing an interested party that the corporation was not for sale, but that a written proposal, if made, would be submitted to the board for review. Additionally, in *Matador Capital Management Corp. v. BRC Holdings, Inc.*,⁷³⁹ the Delaware Chancery Court found unpersuasive the plaintiff's claims that the board failed to consider a potential bidder because the board's decision to terminate discussion was "justified by the embryonic state of [the potential bidder's] proposal."⁷⁴⁰ In particular, the Court stated that the potential bidder did not provide evidence of any real financing capability and conditioned its offer of its ability to arrange the participation of certain members of the target company's management in the transaction.⁷⁴¹

2.7.2. The Board's Consideration. "When a board addresses a pending takeover bid it has an obligation to determine whether the offer is in the best interests of the corporation and its shareholders."⁷⁴² Just as all proposals are not alike, Board responses to proposals may differ. A proposal that is incomplete in material respects should not require serious Board consideration. On the other hand, because more developed proposals may present more of an opportunity for shareholders, they ought to require more consideration by the Board.⁷⁴³

(a) **Matters Considered.** Where an offer is perceived as serious and substantial, an appropriate place for the Board to begin its consideration may be an informed understanding of the corporation's value. This may be advisable whether the Board's ultimate response is to "say no," to refuse to remove pre-existing defensive measures, to adopt new or different defensive measures or to pursue another strategic course to maximize shareholder value. Such a point of departure is consistent with *Van Gorkom* and *Unocal*. In *Van Gorkom*, the Board was found grossly negligent, among other things, for not having an understanding of the intrinsic value of

⁷³⁸ 569 A.2d 53, 55 (Del. 1989).

⁷³⁹ 729 A.2d 280, 292 (Del. Ch. 1998).

⁷⁴⁰ *Id.* at 292.

⁷⁴¹ *Id.*

⁷⁴² *Unocal Corp. v. Mesa Petrol. Co.*, 493 A.2d 946, 954 (Del. 1985).

⁷⁴³ *See Desert Partners, L.P. v. USG Corp.*, 686 F. Supp. 1289, 1300 (N.D. Ill. 1988) (applying Delaware law) ("The Board did not breach its fiduciary duty by refusing to negotiate with Desert Partners to remove the coercive and inadequate aspects of the offer. USG decided not to bargain over the terms of the offer because doing so would convey the image to the market place 'that (1) USG was for sale – when, in fact, it was not; and (2) \$42/share was an 'in the ballpark' price - when, in fact, it was not.'"); *Citron*, 569 A.2d at 63, 66-67 (validating a board's action in approving one bid over another that, although higher on its face, lacked in specifics of its proposed back-end which made the bid impossible to value). *Compare Golden Cycle, LLC v. Allan*, C.A. No. 16301, 1998 WL 892631, at *15-16 (Del. Ch. Dec. 10, 1998) (a board is not required to contact competing bidder for a higher bid before executing a merger agreement where bidder had taken itself out of the board process, refused to sign a confidentiality agreement and appealed directly to the stockholders with a consent solicitation).

the corporation.⁷⁴⁴ In *Unocal*, the inadequacy of price was recognized as a threat for which a proportionate response is permitted.⁷⁴⁵

That is not to say, however, that a Board must “price” the corporation whenever a suitor appears. Moreover, it may be ill advised even to document a range of values for the corporation before the conclusion of negotiations. However, should the decision be made to sell or should a defensive reaction be challenged, the Board will be well served to have been adequately informed of intrinsic value during its deliberations from the beginning.⁷⁴⁶ In doing so, the Board may also establish, should it need to do so under enhanced scrutiny, that it acted at all times to maintain or seek “the best value reasonably available to the stockholders.”⁷⁴⁷ This may also be advisable even if that value derives from remaining independent.

There are, of course, factors other than value to be considered by the Board in evaluating an offer:

In assessing the bid and the bidder’s responsibility, a board may consider, among various proper factors, the adequacy and terms of the offer; its fairness and feasibility; the proposed or actual financing for the offer, and the consequences of that financing; questions of illegality; the impact of both the bid and the potential acquisition on other constituencies, provided that it bears some reasonable relationship to general shareholder interests; the risk of nonconsummation; the basic stockholder interests at stake; the bidder’s identity, prior background and other business venture experiences; and the bidder’s business plans for the corporation and their effects on stockholder interests.⁷⁴⁸

(b) Being Adequately Informed. Although there is no one blueprint for being adequately informed,⁷⁴⁹ the Delaware courts value expert advice, the judgment of directors who are independent and sophisticated, and an active and orderly deliberation.

(1) Investment Banking Advice. Addressing the value of a corporation generally entails obtaining investment banking advice.⁷⁵⁰ The analysis of value requires the “techniques or methods which are generally considered acceptable in the financial community.”⁷⁵¹ Clearly, in *Van Gorkom*, the absence of expert advice prior to the first Board consideration of a merger proposal contributed to the determination that the Board “lacked valuation information adequate to reach an informed business judgment as to the fairness [of the price]” and the finding that the

⁷⁴⁴ *Smith v. Van Gorkom*, 488 A.2d 858, 874 (Del. 1985).

⁷⁴⁵ *Unocal*, 493 A.2d at 955; see also *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1384 (Del. 1995) (noting as a threat “substantive coercion . . . the risk that shareholders will mistakenly accept an underpriced offer because they disbelieve management’s representations of intrinsic value.”).

⁷⁴⁶ See *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 368 (Del. 1993).

⁷⁴⁷ *Paramount Commc’ns Inc. v. QVC Network Inc.*, 637 A.2d 34, 45 (Del. 1994).

⁷⁴⁸ *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1282 n.29 (Del. 1988) (citations omitted).

⁷⁴⁹ See *Goodwin v. Live Entm’t, Inc.*, C.A. No. 15765, 1999 WL 64265, at *21 (Del. Ch. 1999) (citing *Barkan v. Amsted Indus., Inc.*, 567 A.2d 1279, 1286 (1989)).

⁷⁵⁰ See, e.g., *In re Talley Indus., Inc. S’holders Litig.*, C.A. No. 15961, 1998 WL 191939, at *11-12 (Del. Ch. 1998).

⁷⁵¹ *Weinberger v. UOP, Inc.*, 457 A.2d 701, 713 (Del. 1985).

directors were grossly negligent.⁷⁵² Although the Delaware Supreme Court noted that “fairness opinions by independent investment bankers are [not] required as a matter of law,”⁷⁵³ in practice, investment banking advice is typically obtained for a decision to sell and often for a decision not to sell. In the non-sale context, such advice is particularly helpful where there may be subsequent pressure to sell or disclosure concerning the board’s decision not to sell is likely. In either case, however, the fact that the board of directors relies on expert advice to reach a decision provides strong support that the Board acted reasonably.⁷⁵⁴

The advice of investment bankers is not, however, a substitute for the judgment of the directors,⁷⁵⁵ and sole reliance on hired experts and management can ‘taint the design and execution of the transaction.’⁷⁵⁶ In addition, the timing, scope and diligence of the investment bankers may affect the outcome of subsequent judicial scrutiny.⁷⁵⁷

Often all or part of the investment banker’s fee is payable only in the event of success in the transaction. If there is a contingent component in the banker’s fee, the Board should recognize the possible effect of that incentive and, if a transaction is ultimately submitted for shareholder vote, include information about the contingent element among the disclosures to shareholders.⁷⁵⁸

⁷⁵² *Smith v. Van Gorkom*, 488 A.2d 858, 877-78 (Del. 1985).

⁷⁵³ *Id.* at 876.

⁷⁵⁴ *See Goodwin*, 1999 WL 64265, at *22 (“The fact that the Board relied on expert advice in reaching its decision not to look for other purchasers also supports the reasonableness of its efforts.”); *In re Vitalink Commc’ns Corp. S’holders Litig.*, C.A. No. 12085, 1991 WL 238816, at *12 (Del. Ch. 1991) (citations omitted) (relying on the advice of investment bankers supported a finding that the board had a “reasonable basis” to conclude that it obtained the best offer).

⁷⁵⁵ *See In re IXC Commc’ns, Inc. S’holders Litig.*, C.A. Nos. 17324 & 17334, 1999 Del. Ch. LEXIS 210, at *2 (Del. Ch. Oct. 27, 1999) (“No board is obligated to heed the counsel of any of its advisors and with good reason. Finding otherwise would establish a procedure by which this Court simply substitutes advice from Morgan Stanley or Merrill Lynch for the business judgment of the board charged with ultimate responsibility for deciding the best interests of shareholders.”).

⁷⁵⁶ *Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 66 (Del 1989) (citation omitted).

⁷⁵⁷ *See Weinberger v. UOP, Inc.*, 457 A.2d 701, 702 (Del. 1983) (board’s approval of an interested merger transaction did not meet the test of fairness where the fairness analysis prepared by the investment bankers was criticized as “hurried,” due diligence was conducted over a weekend and the price was slipped into the opinion by the banking partner (who was also a director of the corporation) after a quick review of the assembled diligence on a plane flight); *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 349 (Del. 1993) (the Court faulted the valuation package prepared by the investment bankers because they were given limited access to senior officers and directors of company).

⁷⁵⁸ *See Louisiana Municipal Police Employees’ Retirement System v. Crawford*, 918 A.2d 1172, 1190 (Del. Ch. 2007); *Express Scripts, Inc. v. Crawford*, C.A. No. 2663-N, 2007 WL 707550, at *1 (Del. Ch. Feb. 23, 2007) (holding, in each case, that a postponement of the stockholder vote was necessary to provide the target stockholders with additional disclosure that the major part of the financial advisors’ fee was contingent upon the consummation of a transaction by target with its merger partner or a third party). The target’s proxy statement disclosure was found misleading because it did not clearly state that its financial advisors were entitled to the fee only if the initial merger was approved. The Court concluded that disclosure of these financial incentives to the financial advisors was material to the stockholder deliberations on the merger.

(2) Value of Independent Directors, Special Committees. One of the first tasks of counsel in a takeover context is to assess the independence of the Board.⁷⁵⁹ In a sale of control transaction, “the role of outside, independent directors becomes particularly important because of the magnitude of a sale of control transaction and the possibility, in certain cases, that management may not necessarily be impartial.”⁷⁶⁰ As pointed out by the Delaware Supreme Court in *Unocal*, when enhanced scrutiny is applied by the Court, “proof is materially enhanced . . . by the approval of a board comprised of a majority of outside independent directors who have acted [in good faith and after a reasonable investigation].”⁷⁶¹

(i) *Characteristics of an Independent Director.* An independent director has been defined as a non-employee and non-management director.⁷⁶² To be effective, outside directors cannot be dominated by financially interested members of management or a controlling stockholder.⁷⁶³ Care should also be taken to restrict the influence of other interested directors, which may include recusal of interested directors from participation in certain board deliberations.⁷⁶⁴

(ii) *Need for Active Participation.* Active participation of the independent members of the Board is important in demonstrating that the Board did not simply follow management. In *Time*,⁷⁶⁵ the Delaware Supreme Court considered Time’s actions in recasting its previously negotiated merger with Warner into an outright cash and securities acquisition of Warner financed with significant debt to ward off Paramount’s surprise all-cash offer to acquire Time. Beginning immediately after Paramount announced its bid, the Time Board met repeatedly to discuss the bid, determined the merger with Warner to be a better course of action, and declined to open negotiations with Paramount. The outside directors met independently, and the Board sought advice from corporate counsel and financial advisors. Through this process the Board reached its decision to restructure the combination with Warner. The Court viewed favorably the participation of certain of the Board’s 12 independent directors in the analysis of Paramount’s bid. The Time Board’s process contrasts with *Van Gorkom*, where although one-half of Trans Union’s Board was independent, an absence of any inquiry by those directors as to the basis of

⁷⁵⁹ See, e.g., *Kahn v. MSB Bancorp, Inc.*, C.A. No. 14712 NC, 1998 WL 409355, at *3 (Del. Ch. 1998), *aff’d*, 734 A.2d 158 (Del. 1999) (“[T]he fact that nine of the ten directors are not employed by MSB, but are outside directors, strengthens the presumption of good faith.”).

⁷⁶⁰ *Paramount Commc’ns Inc. v. QVC Network Inc.*, 637 A.2d 34, 44 (Del. 1994); see also *Macmillan*, 559 A.2d 1261.

⁷⁶¹ *Unocal Corp. v. Mesa Petrol. Co.*, 493 A.2d 946, 955 (Del 1985).

⁷⁶² *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1375 (Del. 1995); see Appendix D – Effect of Sarbanes-Oxley Act of 2002 on Common Law Fiduciary Duties.

⁷⁶³ See *Macmillan*, 559 A.2d at 1266.

⁷⁶⁴ See *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 366 n.35 (Del 1993). See also *Brehm v. Eisner*, 746 A.2d 244, 257 (Del. 2000) (evaluating a charge that directors breached fiduciary duties in approving employment and subsequent severance of a corporation’s president, the Delaware Supreme Court held that the “issues of disinterestedness and independence” turn on whether the directors were “incapable, due to personal interest or domination and control, of objectively evaluating” an action).

⁷⁶⁵ *Paramount Commc’ns, Inc. v. Time Inc.*, 571 A.2d 1140, 1141 (Del. 1989).

management's analysis and no review of the transaction documents contributed to the Court's finding that the board was grossly negligent in its decision to approve a merger.⁷⁶⁶

(iii) *Use of Special Committee.* When directors or shareholders with fiduciary obligations have a conflict of interest with respect to a proposed transaction, the use of a special committee is recommended. A special committee is also recommended where there is the potential for a conflict to develop.⁷⁶⁷ Accordingly, use of a special committee should be considered in connection with any going-private transaction (i.e., management buy-outs or squeeze-out mergers), asset sales or acquisitions involving entities controlled by or affiliated with directors or controlling shareholders, or any other transactions with majority or controlling shareholders.⁷⁶⁸ If a majority of the Board is disinterested and independent with respect to a proposed transaction (other than a freeze out merger proposal by a controlling stockholder), a special committee may not be necessary, since the Board's decision will be accorded deference under the business judgment rule (assuming, of course, that the disinterested directors are not dominated or otherwise controlled by the interested party(ies)).⁷⁶⁹ In that circumstance, the

⁷⁶⁶ *Smith v. Van Gorkom*, 488 A.2d 858, 893 (Del 1985). *See also Kahn v. Tremont Corp.*, 694 A.2d 422, 429 (Del. 1997) (finding that the three member special committee of outside directors was not fully informed, not active, and did not appropriately simulate an arm's-length transaction, given that two of the three members permitted the other member to perform the committee's essential functions and one of the committee members did not attend a single meeting of the committee).

⁷⁶⁷ *See In re Western Nat'l Corp. S'holders Litig.*, No. 15927, 2000 WL 710192, at *26 (Del. Ch. May 22, 2000) (discussing the use of a special committee where the transaction involved a 46% stockholder; the Court ultimately held that because the 46% stockholder was not a controlling stockholder, the business judgment rule would apply: "[w]ith the aid of its expert advisors, the Committee apprised itself of all reasonably available information, negotiated . . . at arm's length and, ultimately, determined that the merger transaction was in the best interests of the Company and its public shareholders.").

⁷⁶⁸ *See In re Digex, Inc. S'holders Litig.*, 789 A.2d 1176, 1193 (Del. Ch. 2000) (special committee of a company with a controlling corporate shareholder formed to consider potential acquisition offers); *Kohls v. Duthie*, 765 A.2d 1274, 1284 (Del. Ch. 2000) (special committee formed in connection with a management buyout transaction); *T. Rowe Price Recovery Fund, L.P. v. Rubin*, 770 A.2d 536, 539 (Del. Ch. 2000) (special committee used to consider shared service agreements among corporation and its chief competitor, both of which were controlled by the same entity); *In re MAXXAM, Inc./Federated Dev. S'holders Litig.*, 1997 Del. Ch. LEXIS 51 (Del. Ch. Apr. 4, 1997) (special committee formed to consider a purchase of assets from the controlling stockholder); *Citron v. E.I. Du Pont de Nemours & Co.*, 584 A.2d 490 (Del. Ch. 1990) (majority shareholder purchase of minority shares); *Kahn v. Lynch Commc'n Sys., Inc.* ("Lynch P"), 638 A.2d 1110, 1111 (Del. 1994) (special committee formed for controlling shareholder's offer to purchase publicly held shares); *In re Resorts Int'l S'holders Litig.*, 570 A.2d 259, 261 (Del. 1990) (special committee used to evaluate controlling shareholder's tender offer and competing tender offer); *Kahn v. Sullivan*, 594 A.2d 48, 53 (Del. 1991) (special committee formed to evaluate corporation's charitable gift to entity affiliated with the company's chairman and CEO); *Kahn v. Dairy Mart Convenience Stores, Inc.*, No. 124891, 1996 Del. Ch. LEXIS 38, at *2 (Del. Ch. March 29, 1996) (special committee formed to consider management LBO); *Kahn v. Roberts*, 679 A.2d 460, 465 (Del. 1996) (special committee formed to evaluate stock repurchase from 33% shareholder).

⁷⁶⁹ *See In re NYMEX Shareholder Litigation*, C.A. No. 3621-VCN, 2009 Del. Ch. LEXIS 176, at *3 (Del. Ch. Sept. 30, 2009), in which the Chancery Court wrote in granting the defendant directors' motion to dismiss:

The claim that [the Chairman of the Board and the CEO] breached their fiduciary duties by being the sole negotiators with CME [the successful bidder] and not involving the SIC [Strategic Initiatives Committee] in the consideration or negotiation of the acquisition is dismissed. It is well within the business judgment of the Board to determine how merger negotiations will be conducted, and to delegate the task of negotiating to the Chairman and the Chief Executive Officer. Additionally, as the Court has already found that the Board was

disinterested directors may act on behalf of the company and the interested directors should abstain from deliberating and voting on the proposed transaction.⁷⁷⁰

Although there is no legal requirement under Delaware law that an interested Board make use of a special committee, the Delaware courts have indicated that the absence of such a committee in connection with an affiliate or conflict transaction may evidence the transaction's unfairness (or other procedural safeguards, such as a majority of minority vote requirement).⁷⁷¹

(3) Formation of the Committee. Where a majority of the Board is disinterested, a special committee may be useful if there are reasons to isolate the deliberations of the noninterested directors.⁷⁷² Where a majority of the directors have some real or perceived conflict, however, and in the absence of any other procedural safeguards, the formation of a special committee is critical. Ideally, the special committee should be formed prior to the first series of negotiations of a proposed transaction, or immediately upon receipt of an unsolicited merger or acquisition proposal. Formation at a later stage is acceptable, however, if the special committee is still capable of influencing and ultimately rejecting the proposed transaction.⁷⁷³ As

clearly independent, there was no requirement to involve an independent committee in negotiations, nor does the existence of such a committee mandate its use. The allegation that [the Chairman of the Board and the CEO] committed to CME that NYMEX would not renegotiate any of the economic terms of the acquisition is similarly not actionable, since Plaintiffs have not put forth any evidence for how [the Chairman of the Board and the CEO] were capable of binding NYMEX from seeking to modify the terms of the agreement had the Board wanted to. Slip Op. at 20-21.

⁷⁷⁰ See DGCL § 144 (providing that interested director transactions will not be void or voidable solely due to the existence of the conflict if certain safeguards are utilized, including approval by a majority of the disinterested directors, assuming full disclosure).

⁷⁷¹ See *Seagraves v. Urstady Prop. Co.*, C.A. No. 10307, 1996 Del. Ch. LEXIS 36, at *16 (Del. Ch. Apr. 1, 1996) (lack of special committee or other procedural safeguards “evidences the absence of fair dealing”); *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 599 (Del. Ch. 1986) (lack of independent committee is pertinent factor in assessing whether fairness was accorded to the minority); *Boyer v. Wilmington Materials, Inc.*, C.A. No. 12549, 1997 Del. Ch. LEXIS 97, at *20 (Del. Ch. June 27, 1997) (lack of special committee is an important factor in a court’s “overall assessment of whether a transaction was fair”).

⁷⁷² See *Spiegel v. Buntrock*, 571 A.2d 767, 776 n.18 (Del. 1990) (“Even when a majority of a board of directors is independent, one advantage of establishing a special litigation committee is to isolate the interested directors from material information during either the investigative or decisional process”); *Moore Bus. Forms, Inc. v. Cordant Holdings Corp.*, C.A. Nos. 13911, 14595, 1996 Del. Ch. LEXIS 56, at *18-19 (Del. Ch. June 4, 1996) (recommending use of a special committee to prevent shareholder’s board designee’s access to privileged information regarding possible repurchase of shareholder’s preferred stock; “the special committee would have been free to retain separate legal counsel, and its communications with that counsel would have been properly protected from disclosure to [the shareholder] and its director designee”); *Kohls v. Duthie*, 765 A.2d 1274, 1285 (forming a special committee to isolate the negotiations of the noninterested directors from one director that would participate in a management buyout).

⁷⁷³ See *In re SS&C Technologies, Inc. S’holder Litig.*, 911 A.2d 816, 817 (Del. Ch. 2006) (discussing the settlement of litigation challenging a management led cash-out merger that was disapproved in part because the Court was concerned that the buyer’s proposal was solicited by the CEO without prior Board approval as part of informal “test the waters” process to find a buyer who would pay a meaningful premium while allowing the CEO to make significant investment in the acquisition vehicle and continue managing the target). After being satisfied with the buyer’s proposal but before all details had been negotiated, the CEO advised the Board about the deal. The Board then formed special committee that hired independent legal and financial advisers and embarked on a program to solicit other buyers, but the Court was concerned that this process was perhaps too late to affect outcome. The Court expressed concern whether the CEO had

a general rule, however, the special committee should be formed whenever the conflicts of fellow directors become apparent in light of a proposed or contemplated transaction. To the extent possible, the controlling stockholder or the CEO, if interested, should not select, or influence the selection of, the members of the special committee or its chairperson.⁷⁷⁴

(4) Independence and Disinterestedness. In selecting the members of a special committee, care should be taken to ensure not only that the members have no financial interest in the transaction, but that they have no financial ties, or are otherwise beholden, to any person or entity involved in the transaction.⁷⁷⁵ In other words, all committee members should be independent and disinterested. To be disinterested, the member cannot derive any personal (primarily financial) benefit from the transaction not shared by the stockholders.⁷⁷⁶ To be independent, the member's decisions must be "based on the corporate merits of the subject before the [committee] rather than extraneous considerations or influences."⁷⁷⁷ To establish non-independence, a plaintiff has to show that the committee members were "beholden" to the conflicted party or "so under [the conflicted party's] influence that their discretion would be sterilized."⁷⁷⁸ In a case in which committee members appeared to abdicate their responsibilities to another member "whose independence was most suspect," the Delaware Supreme Court reemphasized "it is the care, attention and sense of individual responsibility to the performance of one's duties . . . that generally touches on independence."⁷⁷⁹

misused confidential information and resources of corporation in talking to his selected buyer and engaging an investment banker before Board approval and whether the CEO's precommitment to a deal with the buyer and his conflicts (i.e., receiving cash plus an interest in the acquisition vehicle and continuing management role) prevented the Board from considering whether a sale should take place and, if so, to negotiating the best terms reasonably available.

⁷⁷⁴ See *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1267 (Del. 1988) (noting that, in a case where a special committee had no burden-shifting effect, the interested CEO "hand picked" the members of the committee); *In re Fort Howard Corp. S'holders Litig.*, C.A. No. 9991, 1988 WL 83147, at *12 (Del. Ch. Aug. 8, 1988) ("It cannot . . . be the best practice to have the interested CEO in effect handpick the members of the Special Committee as was, I am satisfied, done here.").

⁷⁷⁵ See *Katell v. Morgan Stanley Group, Inc.*, C.A. No. 12343, 1995 Del. Ch. LEXIS 76, at * 21 (Del. Ch. June 15, 1995) ("When a special committee's members have no personal interest in the disputed transactions, this Court scrutinizes the members' relationship with the interested directors"); E. Norman Veasey, *Duty of Loyalty: The Criticality of the Counselor's Role*, 45 BUS. LAW. 2065, 2079 ("[T]he members of the committee should not have unusually close personal or business relations with the conflicted directors . . .").

⁷⁷⁶ *Pogostin v. Rice*, 480 A.2d 619, 624, 627 (Del. 1984), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244, 253-54 (Del. 2000).

⁷⁷⁷ *Aronson v. Lewis*, 473 A.2d 805, 816 (Del. 19784), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244, 253-54 (Del. 2000); *In re MAXXAM, Inc./Federated Dev. S'holders Litig.*, 659 A.2d 760, 773 (Del. Ch. 1995) ("To be considered independent, a director must not be 'dominated or controlled by an individual or entity interested in the transaction.'") (citing *Grobow v. Perot*, 539 A.2d 180, 189 (Del. 1988) (overruled as to standard of appellate review)). See also *Grimes v. Donald*, 673 A.2d 1207, 1219 n.25 (Del. 1996) (describing parenthetically *Lynch I* as a case in which the "'independent committee' of the board did not act independently when it succumbed to threat of controlling stockholder") (overruled as to standard of appellate review).

⁷⁷⁸ *MAXXAM*, 659 A.2d at 773 (quoting *Rales v. Blasband*, 634 A.2d 927, 936 (Del. 1993)).

⁷⁷⁹ *Kahn v. Tremont Corp.*, 694 A.2d 422, 429-30 (Del. 1997) (citing *Aronson*, 473 A.2d at 816).

If a committee member votes to approve a transaction to appease the interested director/shareholder, to stay in the interested party's good graces, or because he/she is beholden to the interested party for the continued receipt of consulting fees or other payments, such committee member will not be viewed as independent.⁷⁸⁰

(5) Selection of Legal and Financial Advisors. Although there is no legal requirement that a special committee retain legal and financial advisors, committees often retain advisors to help them carry out their duties.⁷⁸¹ The selection of advisors, however, may influence a court's determinations of the independence of the committee and the effectiveness of the process.⁷⁸²

Selection of advisors should be made by the committee after its formation. Although the special committee may rely on the company's professional advisors, perception of the special committee's independence is enhanced by the separate retention of advisors who have no prior affiliation with the company or interested parties.⁷⁸³ Accordingly, the special committee should take time to ensure that its professional advisors have no prior or current, direct or indirect, material affiliations with interested parties.

Retention of legal and financial advisors by the special committee also enhances its ability to be fully informed. Because of the short timeframe of many of today's transactions, professional advisors allow the committee to assimilate large amounts of information more

⁷⁸⁰ *Rales*, 634 A.2d at 936-37; *MAXXAM, Inc./Federated Dev. S'holders Litig.*, C.A. No. 12111, 1997 Del. Ch. LEXIS 51, at *66-71 (Del. Ch. Apr. 4, 1997) (noting that special committee members would not be considered independent due to their receipt of consulting fees or other compensation from entities controlled by the shareholder who controlled the company); *Kahn v. Tremont Corp.*, 694 A.2d 422, 429-30 (Del. 1997) (holding that the special committee "did not function independently" because the members had "previous affiliations with [an indirect controlling shareholder, Simmons,] or companies which he controlled and, as a result, received significant financial compensation or influential positions on the boards of Simmons' controlled companies."); *Kahn v. Dairy Mart Convenience Stores, Inc.*, C.A. No. 12489, 1996 Del. Ch. LEXIS 38, at *18-19 (Del. Ch. Mar. 29, 1996) (noting that the special committee member was also a paid consultant for the corporation, raising concerns that he was beholden to the controlling shareholder).

⁷⁸¹ *See, e.g., Strassburger v. Earley*, 752 A.2d 557, 567 (Del. Ch. 2000) (criticizing a one-man special committee and finding it ineffective in part because it had not been "advised by independent legal counsel or even an experienced investment banking firm.").

⁷⁸² *See Dairy Mart*, 1996 Del. Ch. LEXIS 38, at *22 n.6 (noting that a "critical factor in assessing the reliability and independence of the process employed by a special committee, is the committee's financial and legal advisors and how they were selected"); *In re Fort Howard Corp. S'holders Litig.*, C.A. No. 9991, 1988 WL 83147, at *703 (Del. Ch. Aug. 8, 1988) (discussing that "no role is more critical with respect to protection of shareholder interests in these matters than that of the expert lawyers who guide sometimes inexperienced [committee members] through the process").

⁷⁸³ *See, e.g., Citron v. E.I. Du Pont de Nemours & Co.*, 584 A.2d 490, 494 (Del. Ch. 1990) (noting that to ensure a completely independent review of a majority stockholder's proposal the independent committee retained its own independent counsel rather than allowing management of the company to retain counsel on its behalf); *cf. In re Fort Howard*, 1988 WL 83147, at *719 (noting that the interested CEO had selected the committee's legal counsel; "[a] suspicious mind is made uneasy contemplating the possibilities when the interested CEO is so active in choosing his adversary"); *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1267-68 (Del. 1988) (noting that conflicted management, in connection with an MBO transaction, had "intensive contact" with a financial advisor who subsequently was selected by management to advise the special committee).

quickly and effectively than the committee could without advisors. Having advisors who can efficiently process and condense information is important where the committee is asked to evaluate proposals or competing proposals within days of its making.⁷⁸⁴ Finally, a court will give some deference to the committee's selection of advisors where there is no indication that they were retained for an "improper purpose."⁷⁸⁵

Where the investment bankers are conflicted, the Board's reliance upon them may be impaired. In *In re Del Monte Foods Company Shareholders Litigation*,⁷⁸⁶ the Chancery Court held that the advice Del Monte's Board received from its financial advisor was so conflicted as to give rise to a likelihood of a breach of fiduciary duty, preliminarily enjoined a stockholder vote to approve the transaction, suspended the deal protections provided in the merger agreement and indicated that the bidding buyout firm may face monetary damages as an "aider and abettor" of the potential breach.⁷⁸⁷

⁷⁸⁴ See, e.g., *In re KDI Corp. S'holders Litig.*, C.A. No. 10278, 1990 Del. Ch. LEXIS 201, at *10, Fed. Sec. L. Rep. (CCH) 95727 (Del. Ch. Dec. 13, 1990) (noting that special committee's financial advisor contacted approximately 100 potential purchasers in addition to evaluating fairness of management's proposal).

⁷⁸⁵ See *Clements v. Rogers*, 790 A.2d 1222, 1228 (Del. Ch. 2001) (brushing aside criticism of choice of local banker where there was valid business reasons for the selection).

⁷⁸⁶ 25 A.3d 813, 817 (Del. Ch. 2011).

⁷⁸⁷ In *Del Monte*, several potential acquirers signed customary confidentiality agreements which expressly prohibited them from entering into discussions or arrangements with other potential bidders. Del Monte received several bids, including one from Kohlberg, Kravis, Roberts & Co. ("KKR"), with which the company's financial advisor (Barclays) had a longstanding relationship and from which it expected the lucrative buy-side financing, and another from Vestar Capital Partners, which submitted the highest preliminary bid. During this time, the financial advisor did not disclose to the Board that it planned to seek a role in the buy-side financing that would necessarily be part of a private-equity leveraged acquisition. The Del Monte Board then called off a process of exploring a potential sale in early 2010, its investment bankers continued to meet with several of the bidders—without the approval or knowledge of Del Monte—ultimately yielding a new joint bid from two buyout firms. While still representing the Board and before the parties had reached agreement on price, Del Monte's bankers sought and received permission to provide buy-side financing, which required Del Monte to retain another investment advisor to render an unconflicted fairness opinion. Del Monte reached a high-premium deal with a "go-shop" provision and deal protection devices including a termination fee and matching rights. The original bankers were then tasked with running Del Monte's go-shop process (which yielded no further offers), although the Court noted they stood to earn a substantial fee from financing the pending acquisition.

The opinion in *Del Monte* emphasized the critical role of financial advisors during a sale process, noted that the Court would carefully examine any financial advisor conflicts that might taint the directors' actions in the sale process. The Court took particular exception to a surreptitious and unauthorized pairing of the winning bidders, explaining that a non-conflicted financial advisor could have paired one of the bidders with a different sponsor and increased the prospects for meaningful price competition. Moreover, upon learning of the proposed pairing, Del Monte should not have granted KKR's request to include Vestar in its sponsor group before actively exploring alternative pairings that may have resulted in a higher price for the company's stockholders. Further, the Court concluded that the Board failed to act reasonably by allowing its financial advisor to participate in the buy-side financing prior to reaching an agreement with the buyer on share price and by allowing the financial advisor to oversee the go-shop process, the success of which would jeopardize significant financing fees payable to the financial advisor. The Court determined that the Board, although required by Delaware law to take an active role in the sale process, failed even to inquire whether the financial advisor's participation in the buy-side financing was necessary to complete the deal or had some other justification reasonably related to advancing stockholder interests.

The *Del Monte* case provides a number of reminders for Boards, buyers (in particular private equity firms) and financial advisors: (i) Boards must take an active and direct role in the sale process, even where there is only one bidder; (ii) the target's financial advisor conflicts of interest (actual or potential) will be closely scrutinized by the courts, including prior dealings between the financial advisor and the buyer group and conflicts presented when the financial advisor provides buy-side financing; (iii) financial advisor conflicts (actual or potential) should be fully disclosed to the Board prior to the advisor's engagement, and the Board should be apprised of and consider changes during the term of the engagement that could taint the financial advisor; (iv) if there are good reasons for using a financial advisor with conflicts, the Board should consider retaining a non-conflicted financial advisor for all aspects of the transaction in which the first advisor has a conflict (participation by a target's financial advisor in the buyer's financing group suggests that a different advisor should manage any go-shop process); (v) Buyers should consider their potential liability and transaction risk from misconduct or self-interested activities by the target's financial advisors; (vi) Buyers should adhere to the terms of their confidentiality agreements with the target, including any limitations on partnering with third parties; and (vii) financial advisors should follow process limitations imposed by confidentiality agreements or the Board.⁷⁸⁸

*In re El Paso Corporation Shareholder Litigation*⁷⁸⁹ is another example of a sale process found to have been tainted by conflicts of interest involving the corporation's CEO and its financial advisors. El Paso had two principal businesses: exploration and production ("E&P") and pipelines. To enhance stockholder values, El Paso decided to spin-off its E&P business and retain its pipeline business. It engaged Goldman Sachs as its exclusive financial advisor for the spin-off. After El Paso announced the spin-off plan, it received an unsolicited bid for the entire company from Kinder Morgan. The CEO of El Paso undertook responsibility for negotiating the sale of El Paso to Kinder Morgan, which intended to keep El Paso's pipeline business and sell off El Paso's exploration and production ("E&P") business to finance the purchase, and weakly fended off the first proposal. The CEO became interested in working with other El Paso managers in making a bid to buy the E&P business from Kinder Morgan, but did not disclose to the El Paso Board his interest. Keeping that motive secret, the CEO negotiated the merger, and then approached Kinder Morgan's CEO to try to interest him in the idea (i.e., when the CEO's duty was to get the maximum price from Kinder Morgan, his interest was not in doing that).

This undisclosed conflict of interest compounded the reality that the Board and management of El Paso relied in part on advice given by a financial advisor, Goldman, Sachs &

⁷⁸⁸ Less than a month after *Del Monte*, in *In re Atheros Communications Shareholder Litigation*, No. 6124-VCN, 2011 WL 864928, at *1 (Del. Ch. Mar. 4, 2011), the Court sustained the Board's active handling of the process leading to the sale of the company, including its decision to grant exclusivity to the potential buyer (who refused to proceed further without exclusivity) instead of pursuing negotiations with others at the risk of losing what appeared to be the most serious suitor. The Court, however, faulted the company for its failure to make sufficiently robust disclosure in the merger proxy statement regarding the contingent nature of the investment banker's compensation (the exact amount of the banker's fee that was contingent upon its rendering a fairness opinion should have been disclosed to show its incentive for getting the deal done) and the CEO's expectation of continuing employment with the acquirer (including the date the CEO learned the buyer wanted him post closing), and enjoined the shareholders meeting to vote on the merger pending curative disclosure.

⁷⁸⁹ 41 A.3d 432, 433 (Del. Ch. 2012).

Co., which owned 19% of Kinder Morgan (a \$4 billion investment) and controlled two Kinder Morgan Board seats. Recognizing its conflict, Goldman's representatives on El Paso's Board advised El Paso to retain an independent financial adviser and recused themselves from discussions regarding the potential Kinder merger, although they continued to attend Board meetings at which the merger was discussed. Although a second investment bank (Morgan Stanley) was brought in to address Goldman's conflict, Goldman continued to intervene and advise El Paso on strategic alternatives and structured the compensation of the new investment bank so that it only got paid if El Paso was sold to Kinder Morgan. Goldman was engaged as exclusive financial adviser if El Paso spun off its E&P business and kept Morgan Stanley from being hired as a co-adviser and negotiated a \$20 million fee for itself if the merger was consummated instead of the spin-off, although Goldman nominally was not working on the merger. The lead Goldman banker advising El Paso did not disclose that he personally owned approximately \$340,000 of Kinder Morgan stock.

The Court wrote that while the questionable tactical choices made by the El Paso Board would provide little basis for enjoining a third-party merger approved by a Board overwhelmingly comprised of independent directors, "when there is a reason to conclude that debatable tactical decisions were motivated not by a principled evaluation of the risks and benefits to the company's stockholders, but by a fiduciary's consideration of his own financial or other personal self-interests," *Revlon* scrutiny is implicated. Goldman's conflict became a focal point of Chancellor Strine's concerns:

Although it is true that measures were taken to cabin Goldman's conflict (for example, Goldman formally set up an internal "Chinese wall" between the Goldman advisors to El Paso and the Goldman representatives responsible for the firm's Kinder Morgan investment) – which was actual and potent, not merely potential – those efforts were not effective. Goldman still played an important role in advising the Board by suggesting that the Board should avoid causing Kinder Morgan to go hostile and by presenting information about the value of pursuing the spin-off instead of the Kinder Morgan deal. * * *

Even then, though, Goldman was not out of the picture entirely, as El Paso management only thought it was necessary to limit Goldman's involvement in the Kinder Morgan side of the advisory work. Goldman continued its role as primary financial advisor to El Paso for the spin-off, and was asked to continue to provide financial updates to the Board that would enable the El Paso directors to compare the spin-off to the Merger.

The fact that Goldman continued to have its hands in the dough of the spin-off is important, because the Board was assessing the attractiveness of the Merger relative to the attractiveness of the spin-off. * * *

Heightening these suspicions is the fact that Goldman's lead banker failed to disclose his own personal ownership of approximately \$340,000 in Kinder Morgan stock. * * *

Even worse, Goldman tainted the cleansing effect of Morgan Stanley. Goldman clung to its previously obtained contract to make it the exclusive advisor on the spin-off and which promised Goldman \$25 million in fees if the spin-off was completed. * * *

This makes more questionable some of the tactical advice given by Morgan Stanley and some of its valuation advice, which can be viewed as stretching to make Kinder Morgan's offers more favorable than other available options. Then, despite saying that it did not advise on the Merger – a claim that the record does not bear out in large measure – Goldman asked for a \$20 million fee for its work on the Merger. Of course, by the same logic it used to shut out Morgan Stanley from receiving any fee for the spin-off, Goldman should have been foreclosed from getting fees for working on the Merger when it supposedly was walled off from advising on that deal. But, Goldman's affectionate clients, more wed to Goldman than to logical consistency, quickly assented to this demand.

The CEO's conduct was also faulted by Chancellor Strine:

Worst of all was that the supposedly well-motivated and expert CEO entrusted with all the key price negotiations kept from the Board his interest in pursuing a management buy-out of the Company's E&P business. Knowing that Kinder Morgan intended to sell the E&P business in order to finance its overall purchase of El Paso, [the CEO] spoke with fellow El Paso manager . . . about approaching Kinder Morgan with a management bid for the E&P assets. * * * Rather than disclose that he was contemplating an MBO to the Board, [the CEO] kept this information to himself. * * * After the Merger price was finally set and the Merger Agreement entered into, [the CEO] went to Rich Kinder not once, but twice, to try to get Kinder interested in letting El Paso management bid. Although Kinder did not embrace [the CEO's] idea of an El Paso management led buy-out of the E&P business, the reality is that [the CEO] was interested in being a buyer of a key part of El Paso at the same time he was charged with getting the highest possible price as a seller of that same asset. At no time did [the CEO] come clean to his Board about his self-interest, and he never sought permission from the Board before twice going to the CEO of the company's negotiating adversary.

At a time when [the CEO's] and the Board's duty was to squeeze the last drop of the lemon out for El Paso's stockholders, [the CEO] had a motive to keep juice in the lemon that he could use to make a financial Collins for himself and his fellow managers interested in pursuing an MBO of the E&P business.

Although Chancellor Strine found that the plaintiffs had a reasonable likelihood of success in proving that the merger was tainted by disloyalty, he did not grant the requested preliminary injunction because there was no other bid on the table and the stockholders of El Paso could vote to turn down the merger themselves.

The *El Paso* opinion, like the *Del Monte* opinion, provides guidance to Boards and their advisers for future transactions: (i) Boards should interview potential financial advisors and make appropriate inquiries regarding potential conflicts and how they will be addressed; (ii) as circumstances change, Boards should revisit prior inquiries and seek updated responses; (iii) Boards need to be active and involved in supervising management and advisors, regardless of whether there are potential conflicts but particularly where there might be potential conflicts; and (iv) Board minutes or other written records should be written to demonstrate that the Board carefully considered the pros and cons of various alternatives, particularly those relating to conflicts, as Board decisions regarding potential conflicts may be subject to enhanced scrutiny rather than protected by the business judgment rule.⁷⁹⁰

(6) The Special Committee's Charge: "Real Bargaining Power". From a litigation standpoint, one of the most important documents when defending a transaction that has utilized a special committee is the board resolution authorizing the special committee and describing the scope of its authority.⁷⁹¹ Obviously, if the Board has materially limited the special committee's authority, the work of the special committee will not be given great deference in litigation since the conflicted Board will be viewed as having retained ultimate control over the process.⁷⁹² Where, however, the special committee is given broad authority and permitted to negotiate the best possible transaction, the special committee's work and business decisions will be accorded substantial deference.⁷⁹³

The requisite power of a special committee was addressed initially in *Rabkin v. Olin Corp.*,⁷⁹⁴ where the Court noted that the "mere existence of an independent special committee" does not itself shift the burden of proof with respect to the entire fairness standard of review. Rather, the Court stated that at least two factors are required:

First, the majority shareholder must not dictate the terms of the merger. Second, the special committee must have real bargaining power that it can exercise with the majority shareholder on an arms [sic] length basis. The Hunt special committee was given the narrow mandate of determining the monetary fairness of a non-negotiable offer. [The majority shareholder] dictated the terms of the

⁷⁹⁰ Hon. Justice Myron Steele, *Contemporary Issues for Traditional Director Fiduciary Duties*, University of Arizona (August 1, 2012).

⁷⁹¹ See, e.g., *In re Digex, Inc. S'holders Litig.*, 789 A.2d 1176, 1183 (Del. Ch. 2000) (quoting board resolution which described the special committee's role); *Strassburger*, 752 A.2d at 567 (quoting the board resolution authorizing the special committee); *Kahn v. Sullivan*, 594 A.2d 48, 53 (Del. 1991) (quoting in full the board resolutions creating the special committee and describing its authority).

⁷⁹² See, e.g., *Strassburger*, 752 A.2d at 571 (noting that the "narrow scope" of the committee's assignment was "highly significant" to its finding that the committee was ineffective and would not shift the burden of proof).

⁷⁹³ Compare *Kohls v. Duthie*, 765 A.2d 1274, 1285 (Del. Ch. 2000) (noting the bargaining power, active negotiations and frequent meetings of the special committee and concluding that the special committee process was effective and that defendants would likely prevail at a final hearing) with *International Telecharge, Inc. v. Bomarko, Inc.*, 766 A.2d 437, 440 (Del. 2000) (affirming the trial court's application of the entire fairness standard where the special committee was misinformed and did not engage in meaningful negotiations).

⁷⁹⁴ C.A. No. 7547, 1990 Del. Ch. LEXIS 50, at *18, Fed. Sec. L. Rep. (CCH) 95255 (Del. Ch. Apr. 17, 1990), reprinted in 16 DEL. J. CORP. L. 851 (1991), *aff'd*, 586 A.2d 1202 (Del. 1990) ("*Rabkin*").

merger and there were no arm's length negotiations. Unanimous approval by the apparently independent Hunt board suffers from the same infirmities as the special committee. The ultimate burden of showing by a preponderance of the evidence that the merger was entirely fair thus remains with the defendants.⁷⁹⁵

Even when a committee is active, aggressive and informed, its approval of a transaction will not shift the entire fairness burden of persuasion unless the committee is free to reject the proposed transaction.⁷⁹⁶ As the Court emphasized in *Lynch I*:

The power to say no is a significant power. It is the duty of directors serving on [an independent] committee to approve only a transaction that is in the best interests of the public shareholders, to say no to any transaction that is not fair to those shareholders and is not the best transaction available. It is not sufficient for such directors to achieve the best price that a fiduciary will pay if that price is not a fair price.⁷⁹⁷

Accordingly, unless the interested party can demonstrate it has “replicated a process ‘as though each of the contending parties had in fact exerted its bargaining power at arm’s length,’ the burden of proving entire fairness will not shift.”⁷⁹⁸

Importantly, if there is any change in the responsibilities of the committee due to, for example, changed circumstances, the authorizing resolution should be amended or otherwise supplemented to reflect the new charge.⁷⁹⁹

(7) Informed and Active. A committee with real bargaining power will not cause the burden of persuasion to shift unless the committee exercises that power in an informed and active manner.⁸⁰⁰ The concepts of being active and being informed are interrelated. An informed committee will almost necessarily be active and vice versa.⁸⁰¹

⁷⁹⁵ *Rabkin*, 1990 Del. Ch. LEXIS 50, at *18-19 (citations omitted); see also *Kahn v. Lynch Commc'n Sys., Inc.*, 669 A.2d 79, 82-83 (Del. 1995) (“*Lynch II*”) (noting the Delaware Supreme Court’s approval of the *Rabkin* two-part test).

⁷⁹⁶ *Kahn v. Lynch Commc'n Systems, Inc.*, 638 A.2d 1110, 1120-21 (1994) (“*Lynch I*”) (“[p]articular consideration must be given to evidence of whether the special committee was truly independent, fully informed, and had the freedom to negotiate at arm’s length”); see also *In re First Boston, Inc. S’holders Litig.*, C.A. No. 10338, 1990 Del. Ch. LEXIS 74, at *20, Fed. Sec. L. Rep. (CCH) 95322 (Del. Ch. June 7, 1990) (holding that although the special committee’s options were limited, it retained “the critical power: the power to say no”).

⁷⁹⁷ *Lynch I*, 638 A.2d at 1119 (quoting *In re First Boston, Inc. S’holders Litig.*, No. 10388, 1990 Del. Ch. LEXIS 74, at *20-21).

⁷⁹⁸ *Lynch I*, 638 A.2d at 1121 (quoting *Weinberger v. UOP Inc.*, 457 A.2d 701, 709-710 n.7 (Del 1983)). See also *In re Digex, Inc. S’holders Litig.*, 789 A.2d 1176, 1208-09 (Del. Ch. 2000) (noting that the inability of a special committee to exercise real bargaining power concerning § 203 issues is fatal to the process).

⁷⁹⁹ See, e.g., *In re Resorts Int’l S’holders Litig.*, 570 A.2d 259, 261 (Del. 1990) (discussing situation where special committee initially considered controlling shareholder’s tender offer and subsequently a competing tender offer and proposed settlements of litigation resulting from offers); *Lynch I*, 638 A.2d at 1113 (noting that the board “revised the mandate of the Independent Committee” in light of tender offer by controlling stockholder).

⁸⁰⁰ See, e.g., *Kahn v. Dairy Mart Convenience Stores, Inc.*, C.A. No. 12489, 1996 Del. Ch. LEXIS 38, at *7 (Del. Ch. March 29, 1996) (noting that despite being advised that its duty was “to seek the best result for

To be informed, the committee necessarily must be knowledgeable with respect to the company's business and advised of, or involved in, ongoing negotiations. To be active, the committee members should be involved in the negotiations or at least communicating frequently with the designated negotiator. In addition, the members should meet frequently with their independent advisors so that they can acquire "critical knowledge of essential aspects of the [transaction]."⁸⁰²

Committee members need to rely upon, interact with, and challenge their financial and legal advisors. While reliance is often important and necessary, the committee should not allow an advisor to assume the role of ultimate decision-maker. For example, in *In re Trans World Airlines, Inc. Shareholders Litigation*, the Court determined, in connection with a preliminary injunction application, that substantial questions were raised as to the effectiveness of a special committee where the committee misunderstood its role and "relied almost completely upon the efforts of [its financial advisor], both with respect to the evaluation of the fairness of the price offered and with respect to such negotiations as occurred."⁸⁰³

Similarly, in *Mills Acquisition Co. v. MacMillan, Inc.*,⁸⁰⁴ the Court criticized the independent directors for failing to diligently oversee an auction process conducted by the company's investment advisor that indirectly involved members of management. In this regard, the Court stated:

Without board planning and oversight to insulate the self-interested management from improper access to the bidding process, and to ensure the proper conduct of the auction by truly independent advisors selected by, and answerable only to, the independent directors, the legal complications which a challenged transaction faces under [enhanced judicial scrutiny] are unnecessarily intensified.⁸⁰⁵

2.7.3. Premium For Control. In an M&A transaction, a controlling shareholder will seek to maximize the return on its investment and, in that sense, its interests will be aligned with the minority shareholders. M&A transactions are often complicated and create situations where the interests of the majority and the minority may diverge. Fiduciary duty case law in Texas and

the shareholders, the committee never negotiated for a price higher than \$15"); *Strassburger v. Earley*, 752 A.2d 557, 567 (Del. Ch. 2000) (finding a special committee ineffective where it did not engage in negotiations and "did not consider all information highly relevant to [the] assignment"); *Clements v. Rogers*, 790 A.2d 1222, 1242 (Del. Ch. 2001) (criticizing a special committee for failing to fully understand the scope of the committee's assignment).

⁸⁰¹ *Kahn v. Tremont Corp.*, 694 A.2d 422, 430 (Del. 1997).

⁸⁰² *Id.* at 429-430 (committee member's "absence from all meetings with advisors or fellow committee members, rendered him ill-suited as a defender of the interests of minority shareholders in the dynamics of fast moving negotiations"). See also *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1268 n.9 (Del. 1988) (discussing case where special committee had no burden-shifting effect, and noting that one committee member "failed to attend a single meeting of the Committee"); *Strassburger*, 752 A.2d at 557, 571 (finding an ineffective committee where its sole member did not engage in negotiations and had less than complete information).

⁸⁰³ C.A. No. 9844, 1988 Del. Ch. LEXIS 139, at *12, *22 (Del. Ch. Oct. 21, 1988), *reprinted in* 14 DEL. J. CORP. L. 870 (1989).

⁸⁰⁴ 559 A.2d at 1281.

⁸⁰⁵ *Id.* at 1282 (citing *Weinberger v. UOP, Inc.*, 457 A.2d 701, 709 n.7 (Del. 1983)).

Delaware does not require a controller to penalize itself and accept less in order to afford the minority better terms.⁸⁰⁶ Pro rata treatment is generally a safe harbor.⁸⁰⁷

In Texas, “a majority stockholder who is paid a premium for his stock because of the control that goes with it is under no duty to the corporation or to the minority stockholders to account for such additional profit, unless he has reason to suspect that the purchaser will loot the corporation, or some part of the premium he receives for his stock is in consideration of a business opportunity, or unless the seller’s conduct runs afoul of the”⁸⁰⁸ principle that “a corporate principle is under obligation not to usurp opportunities for personal gain.”⁸⁰⁹

In Delaware, generally a controller’s financial interest in a transaction as a stockholder (such as receiving liquidity value for its shares) does not establish a disabling conflict of interest when the transaction treats all stockholders equally as the interests of all shareholders are aligned,⁸¹⁰ although there could be a conflict if the controller had an urgent need for liquidity that prompted its decision to pursue a sale of the company.⁸¹¹ While “a controlling shareholder may

⁸⁰⁶ *In re Synthes, Inc. S’holder Litig.*, 50 A.3d 1022, 1036 (Del. Ch. 2012).

⁸⁰⁷ *Id.*; see *In re CompuCom Sys., Inc. S’holders Litig.*, 2005 WL 2481325, at *6 (Del. Ch. Sept. 29, 2005) (“[A]s the owner of a majority share, the controlling shareholder’s interest in maximizing value is directly aligned with that of the minority.”).

⁸⁰⁸ *Thompson v. Hambrick*, 508 S.W.2d 949 (Tex. Civ. App.—Dallas 1974), writ refused NRE (Sept. 24, 1974); see also *Riebe v. National Loan Investors, L.P.*, 828 F. Supp. 453 (N.D. Tex. 1993) (“If denying minority shareholders the benefits of the majority’s sale of the controlling stock at a premium does not breach a fiduciary duty to the minority, then, a fortiori, the mere exclusion of the minority from a sale where the majority did not even obtain a premium does not breach a fiduciary duty.”); *Calvert v. Capital Southwest Corp.*, 441 S.W.2d 247 (Tex. Civ. App.—Austin 1969), writ refused NRE (Oct. 1, 1969) (“Shares of the minority, as to price per share, may sell for much less than the price per share of the majority or of the component members of the majority, or of an individual or group who may own much less than the majority of the outstanding stock but who may still exercise an influential or dominant control over the directors and officers of the corporation. Or, the shares of the minority may have a market value measured by only a small percentage of the value of the majority shares; or such minority shares might have hardly any value at all.”); but cf. *Schautteet v. Chester State Bank*, 707 F. Supp. 885 (E.D. Tex. 1988) (“Under Texas decisional law, a minority shareholder has a direct action against a majority shareholder for wrongfully obtaining a premium for selling control of a corporation.”);

⁸⁰⁹ *International Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567 (Tex. 1963) (corporation itself sued several of its former officers and directors, alleging that they had violated their fiduciary duties by selling their stock in direct competition to a new offering by the corporation; court held defendants had appropriated a corporate opportunity in conflict with the directors’ responsibility of their uncorrupted business judgment for the sole benefit of the corporation; that they owed the corporation the duty to exert all efforts in its behalf to the end that the sale of its stock would net the corporation the greatest possible return and that under the circumstances of this case the burden was on the defendants to establish the fairness to the corporation of their personal sales transactions).

⁸¹⁰ See *In re Anderson, Clayton S’holders Litig.*, 519 A.2d 680, 687 (Del. Ch. 1986); *In re Ply Gem Indus., Inc. S’holders Litig.*, 2001 WL 755133, at *7 (Del. Ch. June 26, 2001) (finding no improper benefit when “[t]here [was] no allegation that any of the remaining directors obtained any improper benefit whatsoever from the merger other than from their entitlement, as shareholders, to receive the merger consideration,” and the directors “received the merger consideration on the same terms as any other shareholder”).

⁸¹¹ See *In re John Q. Hammons Hotels Inc. S’holder Litig.*, 2009 WL 3165613, at *12 (Del. Ch. Oct. 2, 2009) (concluding that the plaintiffs invoked entire fairness review when the evidence suggested that the controlling stockholder was effectively “competing” with the minority for portions of the consideration that the acquiror was willing to pay).

not utilize his control to deprive minority shareholders of the value of their stock,”⁸¹² a controlling stockholder may receive a premium reflecting the value of its controlling interest.⁸¹³

2.7.4. Disparate Treatment of Stockholders. In a merger there are often situations where it is desired to treat shareholders within the same class differently. For example, a buyer may not want to expose itself to the costs and delays that may be associated with issuing securities to shareholders of the target who are not “*accredited investors*” within the meaning of Rule 501(a) of Regulation D under the Securities Act of 1933. In such a situation, the buyer may seek to issue shares only to accredited investors and pay equivalent value on a per share basis in cash to unaccredited investors.

DGCL § 251(b) provides, in relevant part, that “[an] agreement of merger shall state: . . . (5) the manner, if any, of converting the shares of each of the constituent corporations into shares or other securities of the corporation surviving or resulting from the merger or consolidation, or of cancelling some or all of such shares, and, if any shares of any of the constituent corporations are not to remain outstanding, to be converted solely into shares or other securities of the surviving or resulting corporation, or to be cancelled, the cash, property, rights or securities of any other corporation or entity which the holders of such shares are to receive in exchange for, or upon conversion of such shares and the surrender of any certificates evidencing them, which cash, property, rights or securities of any other corporation or entity may be in addition to or in lieu of shares or other securities of the surviving or resulting corporation.”⁸¹⁴ Similarly, TBOC § 10.002 provides that “[a] plan of merger must include . . . the manner and basis of converting any of the ownership or membership interests of each organization that is a party to the merger into: (A) ownership interests, membership interests, obligations, rights to purchase securities, or other securities of one or more of the surviving or new organizations; (B) cash; (C) other property, including ownership interests, membership interests, obligations, rights to purchase securities, or other securities of any other person or entity; or (D) any combination of the items described by Paragraphs (A)-(C).”⁸¹⁵ Further, “[i]f the plan of merger provides for a manner and basis of converting an ownership or membership interest that may be converted in a manner or basis different than any other ownership or membership interest of the same class or series of the

⁸¹² *Thorpe v. Cerbco, Inc.*, 1993 WL 443406, at *7 (Del. Ch. Oct. 29, 1993).

⁸¹³ See *In re Synthes, Inc. S’holder Litig.*, 50 A.3d 1022, 1036 (Del. Ch. 2012); *Abraham v. Emerson Radio Corp.*, 901 A.2d 751, 753 (Del. Ch. 2006) (“Under Delaware law, a controller remains free to sell its stock for a premium not shared with the other stockholders except in very narrow circumstances.”); *In re Fuqua Industries, Inc. Shareholder Litigation*, C.A. No. 11974, (Del. Ch. Dec. 14, 2004); *In re BHC Commc’ns S’holder Litig., Inc.*, 789 A.2d 1, 11 (Del. Ch. 2001) (noting that “the mere fact that Chris-Chraft’s stockholders are to receive merger consideration reflecting a control premium not shared with stockholders of BHC and UTV does not support an inference of breach of fiduciary duty.”); *Mendel v. Carroll*, 651 A.2d 297, 305 (Del. Ch. 1994) (“The law has acknowledged, albeit in a guarded and complex way, the legitimacy of the acceptance by controlling shareholders of a control premium.”); *In re Sea-Land Corp. S’holders Litig.*, 1987 WL 11283, at *5 (Del. Ch. May 22, 1987) (“A controlling stockholder is generally under no duty to refrain from receiving a premium upon the sale of his controlling stock.”); but see *In re Delphi Financial Group Shareholder Litigation*, C.A. No. 7144-VCG, 2012 Del. Ch. LEXIS 45, at *3 (Del. Ch. Mar. 6, 2012) (control premium not permitted due to express Charter provision). see generally Einer Elhauge, *The Triggering Function of Sale of Control Doctrine*, 59 U. Chi. L. Rev. 1465 (1992).

⁸¹⁴ 8 Del. C. § 251(b).

⁸¹⁵ TBOC § 10.002(a)(5); see also TBCA art. 5.01(B).

ownership or membership interest, the manner and basis of conversion must be included in the plan of merger in the same manner as provided by Subsection (a)(5).”⁸¹⁶

DGCL § 251(b)(5) and the Texas Corporate Statutes do not by their literal terms require that all shares of the same class of a constituent corporation in a merger be treated identically in a merger effected in accordance therewith.⁸¹⁷ Certain Delaware court decisions provide guidance. In *Jedwab v. MGM Grand Hotels, Inc.*,⁸¹⁸ a preferred stockholder of MGM Grand Hotels, Inc. (“*MGM*”) sought to enjoin the merger of MGM with a subsidiary of Bally Manufacturing Corporation whereby all stockholders of MGM would receive cash. The plaintiff challenged the apportionment of the merger consideration among the common and preferred stockholders of MGM. The controlling stockholder of MGM apparently agreed, as a facet of the merger agreement, to accept less per share for his shares of common stock than the other holders of common stock would receive on a per share basis in respect of the merger. While the primary focus of the opinion in *Jedwab* was the allocation of the merger consideration between the holders of common stock and preferred stock, the Court also addressed the need to allocate merger consideration equally among the holders of the same class of stock. In this respect, the Court stated that “should a controlling shareholder for whatever reason (to avoid entanglement in litigation as plaintiff suggests is here the case or for other personal reasons) elect to sacrifice some part of the value of his stock holdings, the law will not direct him as to how what amount is to be distributed and to whom.”⁸¹⁹ According to the Court in *Jedwab*, therefore, there is no per se statutory prohibition against a merger providing for some holders of a class of stock to receive less than other holders of the same class if the holders receiving less agree to receive such lesser amount.⁸²⁰

In *Jackson v. Turnbull*,⁸²¹ plaintiffs brought an action pursuant to DGCL § 225 to determine the rightful directors and officers of L’Nard Restorative Concepts, Inc. (“*L’Nard*”) and claimed, among other things, that a merger between Restorative Care of America, Inc. (“*Restorative*”) and L’Nard was invalid. The merger agreement at issue provided that the L’Nard common stock held by certain L’Nard stockholders would be converted into common stock of the corporation surviving the merger and that the common stock of L’Nard held by

⁸¹⁶ TBOC § 10.002(c); see also TBCA art. 5.01(B).

⁸¹⁷ Compare *Beaumont v. American Can Co.*, 538 N.Y.S.2d 136, *137 (N.Y. Sup. Ct. 1991) (determining that unequal treatment of stockholders violates the literal provisions of N.Y. Bus. Corp. Law § 501(C), which requires that “each share shall be equal to every other share of the same class”); see DAVID A. DREXLER ET AL., *DELAWARE CORPORATION LAW AND PRACTICE* § 35.04[1], at 35-11 (1997).

⁸¹⁸ 509 A.2d 584, 586 (Del. Ch. 1986).

⁸¹⁹ *Id.* at 598.

⁸²⁰ See *Emerson Radio Corp. v. Int’l Jensen Inc.*, C.A. No. 15130, slip op. at 33-34 (Del. Ch. Apr. 30, 1996); R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, *THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS* § 9.10 (2d ed. 1997); DAVID A. DREXLER ET AL., *DELAWARE CORPORATION LAW AND PRACTICE* § 35.04[1] (1997); see also *In re Reading Co.*, 711 F.2d 509, 517 (3d Cir. 1983) (applying Delaware law, the Court held that stockholders may be treated less favorably with respect to dividends when they consent to such treatment); *Schrage v. Bridgeport Oil Co., Inc.*, 71 A.2d 882, 883 (Del. Ch. 1950) (holding, in enjoining the implementation of a plan of dissolution, that the plan could have provided for the payment of cash to certain stockholders apparently by means of a cafeteria-type plan in lieu of an in-kind distribution of the corporation’s assets).

⁸²¹ C.A. No. 13042, 1994 WL 174668, at *1 (Del. Ch. Feb. 8, 1994), *aff’d*, 653 A.2d 306 (Del. 1994).

certain other L’Nard stockholders would be converted into the right to receive a cash payment. The plaintiffs argued that the merger violated DGCL § 251(b)(5) by, *inter alia*, forcing stockholders holding the same class of stock to accept different forms of consideration in a single merger. The Court in *Jackson* ultimately found the merger to be void upon a number of grounds, including what it found to be an impermissible delegation of the L’Nard directors’ responsibility to determine the consideration payable in the merger. In respect of the plaintiffs’ claims that the merger was void under DGCL § 251, the Chancery Court rejected such a claim as not presenting a statutory issue. The clear implication of the Court’s decision in *Jackson* is the decision to treat holders of shares of the same class of stock in a merger differently is a fiduciary, not a statutory, issue.

Even though a merger agreement providing for different treatment of stockholders within the same class appears to be authorized by both DGCL and the Texas Corporate Statutes, the merger agreement may still be challenged on grounds that the directors violated their fiduciary duties of care and loyalty in approving the merger. In *In re Times Mirror Co. Shareholders Litigation*,⁸²² the Court approved a proposed settlement in connection with claims pertaining to a series of transactions which culminated with the merger of The Times Mirror Company (“*Times Mirror*”) and Cox Communications, Inc. The transaction at issue provided for: (i) certain stockholders of Times Mirror related to the Chandler family to exchange (prior to the merger) outstanding shares of Times Mirror Series A and Series C common stock for a like number of shares of Series A and Series C common stock, respectively, of a newly formed subsidiary, New TMC Inc. (“*New TMC*”), as well as the right to receive a series of preferred stock of New TMC; and (ii) the subsequent merger whereby the remaining Times Mirror stockholders (i.e., the public holders of Times Mirror Series A and Series C common stock) would receive a like number of shares of Series A and Series C common stock, respectively, of New TMC and shares of capital stock in the corporation surviving the merger. Although holders of the same class of stock were technically not being disparately treated in respect of a merger since the Chandler family was to engage in the exchange of their stock immediately prior to the merger (and therefore *Times Mirror* did not present as a technical issue a statutory claim under DGCL § 251(b)(5)), the Court recognized the somewhat differing treatment in the transaction taken as a whole. As the Court inquired, “[i]s it permissible to treat one set of shareholders holding a similar security differently than another subset of that same class?”⁸²³ The Court in *Times Mirror* was not required to finally address the issue of disparate treatment of stockholders since the proceeding was a settlement proceeding. Therefore, the Court was merely required to assess the strengths and weaknesses of the claims being settled. The Court nonetheless noted that “[f]or a long time I think that it might have been said that [the discriminatory treatment of stockholders] was not permissible,” but then opined that “I am inclined to think that [such differing treatment] is permissible.”⁸²⁴ In addition to noting that *Unocal v. Mesa Petroleum Co.*,⁸²⁵ -- which permitted a discriminatory stock repurchase as a response to a hostile takeover bid -- would be relevant in deciding such issue, the Court noted that an outright prohibition of discriminatory treatment among holders of the same class of stock would be inconsistent with policy concerns. In this

⁸²² C.A. No. 13550, 1994 WL 1753203, at *1 (Del. Ch. Nov. 30, 1994) (Bench Ruling).

⁸²³ *Id.*

⁸²⁴ *Id.*

⁸²⁵ 493 A.2d 946, 949 (Del. 1985).

respect, the Court noted “that a controlling shareholder, so long as the shareholder is not interfering with the corporation’s operation of the transaction, is itself free to reject any transaction that is presented to it if it is not in its best interests as a shareholder.”⁸²⁶ Therefore, if discriminatory treatment among holders of the same class of stock were not permitted in certain circumstances:

[T]hen you might encounter situations in which no transaction could be done at all. And it is not in the social interest – that is, the interest of the economy generally – to have a rule that prevents efficient transactions from occurring.

What is necessary, and I suppose what the law is, is that such a discrimination can be made but it is necessary in all events that both sets of shareholders be treated entirely fairly.⁸²⁷

2.7.5. Protecting the Merger. During the course of acquisition negotiations, it may be neither practicable nor possible to auction or actively shop the corporation. Moreover, even when there has been active bidding by two or more suitors, it may be difficult to determine whether the bidding is complete. In addition, there can remain the possibility that new bidders may emerge that have not been foreseen. In these circumstances, it is generally wise for the Board to make some provision for further bidders in the merger agreement.⁸²⁸ Such a provision can also provide the board with additional support for its decision to sell to a particular bidder if the agreement does not forestall competing bidders, permits the fact gathering and discussion sufficient to make an informed decision and provides meaningful flexibility to respond to them. In this sense, the agreement is an extension of, and has implications for, the process of becoming adequately informed.

In considering a change of control transaction, a Board should consider:

[W]hether the circumstances afford a disinterested and well motivated director a basis reasonably to conclude that if the transactions contemplated by the merger agreement close, they will represent the best available alternative for the corporation and its shareholders. This inquiry involves consideration *inter alia* of the nature of any provisions in the merger agreement tending to impede other offers, the extent of the board’s information about market alternatives, the content of announcements accompanying the execution of the merger agreement, the extent of the company’s contractual freedom to supply necessary information to competing bidders, and the time made available for better offers to emerge.⁸²⁹

⁸²⁶ *Id.*

⁸²⁷ *In re Times Mirror*, 1994 WL 1753203, at *1.

⁸²⁸ *See In re NYSE Euronext Shareholders Litigation*, C.A. No. 8136-CS (Del. Ch. May 10, 2013) (TRANSCRIPT) (Chancellor Strine declined to enjoin preliminarily a stockholder vote on the proposed merger, but nonetheless criticized a provision in the merger agreement that restricted the target’s board’s ability to change its recommendation when faced with a partial-company competing bid), *available at* www.rlf.com/files/6884_NE051013Rulings.pdf.

⁸²⁹ *Roberts v. General Instrument Corp.*, C.A. No. 11639, 1990 WL 118356, at *8 (Del. Ch. Aug. 13, 1990).

The Board will, however, have to balance the requirements of the buyer against these interests in negotiating the merger agreement. The buyer will seek assurance of the benefit of its bargain through the agreement, especially the agreed upon price, and the corporation may run the risk of losing the transaction if it does not accede to the buyer's requirements in this regard. The relevant cases provide the corporation and its directors with the ability, and the concomitant obligation in certain circumstances, to resist.

The assurances a buyer seeks often take the form of a "no-shop" clause, a "lock-up" agreement for stock or assets, a break-up fee, or a combination thereof. In many cases, a court will consider the effect of these provisions together. Whether or not the provisions are upheld may depend, in large measure, on whether a court finds that the Board has adequate information about the market and alternatives to the offer being considered. The classic examples of no-shops, lock-ups and break-up fees occur, however, not in friendly situations, where a court is likely to find that such arrangements provide the benefit of keeping the suitor at the bargaining table, but rather in a bidding war between two suitors, where the court may find that such provisions in favor of one suitor prematurely stop an auction and thus do not allow the Board to obtain the highest value reasonably attainable.

The fact that a buyer has provided consideration for the assurances requested in a merger agreement does not end the analysis. In *QVC*, the Delaware Supreme Court took the position that provisions of agreements that would force a Board to violate its fiduciary duty of care are unenforceable. As the Court stated:

Such provisions, whether or not they are presumptively valid in the abstract, may not validly define or limit the directors' fiduciary duties under Delaware law or prevent the . . . directors from carrying out their fiduciary duties under Delaware law. To the extent such provisions are inconsistent with those duties, they are invalid and unenforceable.⁸³⁰

Although this language provides a basis for directors to resist unduly restrictive provisions, it may be of little comfort to a Board that is trying to abide by negotiated restrictive provisions in an agreement and their obligations under Delaware law, especially where the interplay of the two may not be entirely clear.

(a) No-Shops. The term "*no-shop*" is used generically to describe both provisions that limit a corporation's ability to actively canvas the market (the "no shop" aspect) or to respond to overtures from the market (more accurately, a "*no talk*" provision). No-shop clauses can take different forms. A strict no-shop allows no solicitation and also prohibits a target from facilitating other offers, all without exception. Because of the limitation that a strict no-shop imposes on the Board's ability to become informed, such a provision is of questionable validity.⁸³¹ A customary, and limited, no-shop clause contains some type of "*fiduciary out*,"

⁸³⁰ *Paramount Commc'ns Inc. v. QVC Network Inc.*, 637 A.2d 34, 48 (Del. 1994).

⁸³¹ *See Phelps Dodge Corp. v. Cyprus Amax Minerals Co.*, C.A. Nos. 17383, 17398, 17427, 1999 WL 1054255, at *1 (Del. Ch. Sept. 27, 1999); *ACE Ltd. v. Capital Re Corp.*, 747 A. 2d 95, 96 (Del. Ch. 1999) (expressing view that certain no-talk provisions are "particularly suspect"); but *see In re IXC Commc'ns, Inc. S'holders Litig.*, C.A. Nos. 17324 & 17334, 1999 Del. Ch. LEXIS 210, at *1 (Del. Ch. Oct. 27, 1999) (no talk provisions "are common in merger agreements and do not imply some automatic breach of fiduciary duty"); *see* Mark Morton, Michael Pittenger & Mathew Fischer, *Recent Delaware Law*

which allows a Board to take certain actions to the extent necessary for the Board to comply with its fiduciary duties to shareholders.⁸³² Board actions permitted can range from supplying confidential information about the corporation to unsolicited suitors, to negotiating with unsolicited suitors and terminating the existing merger agreement upon payment of a break-up fee, to actively soliciting other offers.⁸³³ Each action is tied to a determination by the Board, after advice of counsel, that it is required in the exercise of the Board's fiduciary duties. Such "fiduciary outs," even when restrictively drafted, will likely be interpreted by the courts to permit the Board to become informed about an unsolicited competing bid. "[E]ven the decision not to negotiate . . . must be an informed one. A target can refuse to negotiate [in a transaction not involving a sale of control] but it should be informed when making such refusal."⁸³⁴

In *ACE Limited v. Capital Re Corporation*,⁸³⁵ which did not involve a change in control merger, the Court interpreted a "no-talk" provision of a "no-shop" to permit the Board to engage in continued discussions with a continuing bidder, notwithstanding the signing of a merger agreement, when not to do so was tantamount to precluding the stockholders from accepting a higher offer. The Court wrote:

QVC does not say that directors have no fiduciary duties when they are not in "Revlon-land." ...Put somewhat differently, *QVC* does not say that a board can, in all circumstances, continue to support a merger agreement not involving a change of control when: (1) the board negotiated a merger agreement that was tied to voting agreements ensuring consummation if the board does not terminate the agreement; (2) the board no longer believes that the merger is a good transaction for the stockholders; and (3) the board believes that another available transaction is more favorable to the stockholders. The fact that the board has no *Revlon* duties does not mean that it can contractually bind itself to set idly by and allow an unfavorable and preclusive transaction to occur that its own actions have brought about. The logic of *QVC* itself casts doubts on the validity of such a contract.⁸³⁶

In *Cirrus Holding v. Cirrus Ind.*,⁸³⁷ the Court wrote in denying the petition by a purchaser who had contracted to buy from a closely held issuer 61% of its equity for a preliminary injunction barring the issuer from terminating the purchase agreement and accepting a better deal that did not involve a change in control:

Developments Concerning No-Talk Provisions: From "Just Say No" to "Can't Say Yes," V DEAL POINTS No. 1 (Mar. 2000) (discussing these cases in the News-Letter of the ABA Bus. L. S. Committee on Negotiated Acquisitions).

⁸³² See, e.g., *Matador Capital Mgmt. Corp. v. BRC Holdings*, 729 A.2d 280, 288-89 (Del. Ch. 1998); William T. Allen, *Understanding Fiduciary Outs: The What and Why of an Anomalous Concept*, 55 BUS. LAW. 653 (2000).

⁸³³ See Allen, *supra* note 832.

⁸³⁴ *Phelps Dodge Corp. v. Cyprus Amax Minerals Co.*, C.A. Nos. 17383, 17398, 17427, 1999 WL 1054255, at *1 (Del. Ch. Sept. 27, 1999).

⁸³⁵ 747 A.2d 95, 96 (Del. Ch. 1999).

⁸³⁶ *Id.* at 107-08.

⁸³⁷ 794 A.2d 1191, 1193 (Del. Ch. 2001).

As part of this duty [to secure the best value reasonably available to the stockholders], directors cannot be precluded by the terms of an overly restrictive “no-shop” provision from all consideration of possible better transactions. Similarly, directors cannot willfully blind themselves to opportunities that are presented to them, thus limiting the reach of “no talk” provisions. The fiduciary out provisions also must not be so restrictive that, as a practical matter, it would be impossible to satisfy their conditions. Finally, the fiduciary duty did not end when the Cirrus Board voted to approve the SPA. The directors were required to consider all available alternatives in an informed manner until such time as the SPA was submitted to the stockholders for approval.⁸³⁸

Although determinations concerning fiduciary outs are usually made when a serious competing suitor emerges, it may be difficult for a Board or its counsel to determine just how much of the potentially permitted response is required by the Board’s fiduciary duties.⁸³⁹ As a consequence, the Board may find it advisable to state the “fiduciary out” in terms that do not only address fiduciary duties, but also permit action when an offer, which the Board reasonably believes to be “superior,” is made.

(b) Lock-ups. Lock-ups can take the form of an option to buy additional shares of the corporation to be acquired, which benefits the suitor if the price for the corporation increases after another bidder emerges and discourages another bidder by making the corporation more expensive or by giving the buyer a head start in obtaining the votes necessary to approve the transaction.⁸⁴⁰ Lock-ups can also take the form of an option to acquire important assets (a company’s “*crown jewels*”) at a price that may or may not be a bargain for the suitor, which may so change the attractiveness of the corporation as to discourage or preclude other suitors.

⁸³⁸ *Id.* at 1207.

⁸³⁹ See John F. Johnston, *Recent Amendments to the Merger Sections of the DGCL Will Eliminate Some - But Not All - Fiduciary Out Negotiation and Drafting Issues*, 1 Mergers & Acquisitions L. Rep. (BNA) 777, 779 (1998):

[I]n freedom-of-contract jurisdictions like Delaware, the target board will be held to its bargain (and the bidder will have the benefit of its bargain) only if the initial agreement to limit the target board’s discretion can withstand scrutiny under applicable fiduciary duty principles. The exercise of fiduciary duties is scrutinized up front -- at the negotiation stage. If that exercise withstands scrutiny, fiduciary duties will be irrelevant in determining what the target board’s obligations are when a better offer, in fact, emerges; at that point its obligations will be determined solely by the contract.

Id. at 779.

⁸⁴⁰ Such an option is issued by the corporation, generally to purchase newly issued shares for up to 19.9% of the corporation’s outstanding shares at the deal price. The amount is intended to give the bidder maximum benefit without crossing limits established by the New York Stock Exchange (see Rule 312.03, NYSE Listed Company Manual) or NASD (see Rule 4310(c)(25)(H)(i), NASD Manual – The NASDAQ Stock Market) that require shareholder approval for certain large stock issuances. Such an option should be distinguished from options granted by significant shareholders or others in support of the deal. Shareholders may generally grant such options as their self-interest requires. See *Mendel v. Carroll*, 651 A.2d 297, 306 (Del. Ch. 1994). However, an option involving 15% or more of the outstanding shares generally will trigger DGCL § 203, which section restricts certain transactions with shareholders who acquire such amount of shares without board approval. Any decision to exempt such an option from the operation of DGCL § 203 involves the board’s fiduciary duties.

“[L]ock-ups and related agreements are permitted under Delaware law where their adoption is untainted by director interest or other breaches of fiduciary duty.”⁸⁴¹ The Delaware Supreme Court has tended to look askance at lock-up provisions when such provisions, however, impede other bidders or do not result in enhanced bids. As the Delaware Supreme Court stated in *Revlon*,

Such [lock-up] options can entice other bidders to enter a contest for control of the corporation, creating an auction for the company and maximizing shareholder profit. . . . However, while those lock-ups which draw bidders into the battle benefit shareholders, similar measures which end an active auction and foreclose further bidding operate to the shareholders detriment.⁸⁴²

As the cases that follow indicate, the Delaware courts have used several different types of analyses in reviewing lock-ups. In active bidding situations, the courts have examined whether the lock-up resulted in an enhanced bid (in addition to the fact that the lock-up ended an active auction).⁸⁴³ In situations not involving an auction, the courts have examined whether the lock-up impeded other potential suitors, and if an active or passive market check took place prior to the grant of the lock-up.⁸⁴⁴

(c) Break-Up Fees. Break-up fees generally require the corporation to pay consideration to its merger partner should the corporation be acquired by a competing bidder who emerges after the merger agreement is signed to compensate the merger partner for the opportunity lost when the competing bidder disrupts the agreed transaction and for effectively acting as a stalking horse. As with no-shops and lock-ups, break-up fees are not invalid unless they are preclusive or an impediment to the bidding process.⁸⁴⁵ As the cases that follow indicate,

⁸⁴¹ *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 176 (Del 1986).

⁸⁴² *Id.* at 183.

⁸⁴³ *See id.* at 173; *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1264 (Del. 1989).

⁸⁴⁴ *See Matador Capital Mgmt. Corp. v. BRC Holdings*, 729 A.2d 280, 291 (Del. Ch. 1998); *Rand v. Western Air Lines, Inc.*, C.A. No. 8632, 1994 WL 89006, at *1 (Del. Ch. Feb. 25, 1994); *Roberts v. Gen. Instrument Corp.*, C.A. No. 11639, 1990 WL 118356, at *1 (Del. Ch. Aug. 13, 1990). For a further discussion of the analytical approaches taken by the Delaware courts, *see* Fraidin and Hanson, *Toward Unlocking Lock-ups*, 103 Yale L.J. 1739, 1748-66 (1994).

⁸⁴⁵ Alternatively, if parties to a merger agreement expressly state that the termination fee will constitute liquidated damages, Delaware courts will evaluate the termination fee under the standard for analyzing liquidated damages. For example, in *Brazen v. Bell Atlantic Corp.*, Bell Atlantic and NYNEX entered into a merger agreement which included a two-tiered termination fee of \$550 million, which represented about 2% of Bell Atlantic’s market capitalization and would serve as a reasonable measure for the opportunity cost and other losses associated with the termination of the merger. 695 A.2d 43, 45 (Del. 1997). The merger agreement stated that the termination fee would “constitute liquidated damages and not a penalty.” *Id.* at 46. Consequently, the Court found “no compelling justification for treating the termination fee in this agreement as anything but a liquidated damages provision, in light of the express intent of the parties to have it so treated.” *Id.* at 48. Rather than apply the business judgment rule, the Court followed “the two-prong test for analyzing the validity of the amount of liquidated damages: ‘Where the damages are uncertain and the amount agreed upon is reasonable, such an agreement will not be disturbed.’” *Id.* at 48 (citation omitted). Ultimately, the Court upheld the liquidated damages provision. *Id.* at 50. The Court reasoned in part that the provision was within the range of reasonableness “given the undisputed record showing the size of the transaction, the analysis of the parties concerning lost opportunity costs, other expenses, and the arms-length negotiations.” *Id.* at 49.

however, break-up fees are not as disliked by the Delaware courts, and such fees that bear a reasonable relation to the value of a transaction so as not to be preclusive have been upheld.⁸⁴⁶ Delaware courts generally consider a 3% of equity value break-up fee to be reasonable.⁸⁴⁷ In practice, counsel are generally comfortable with break-up fees that range up to 4% of the equity value of the transaction and a fee of up to 5% may be justified in connection with certain smaller transactions. A court, when considering the validity of a fee, will consider the aggregate effect of that fee and all other deal protections.⁸⁴⁸ As a result, a 5% fee may be reasonable in one case and a 2.5% fee may be unreasonable in another case. A termination fee may be based on either equity or enterprise value.⁸⁴⁹

2.7.6. Post Signing Market Check/“Go-Shop”. A “go-shop” is a provision in a merger agreement that permits a target company, after executing a merger agreement, to continue to actively solicit bids and negotiate with other potential bidders for a defined period of time:

A typical go-shop provision permits a target company to solicit proposals and enter into discussions or negotiations with other potential bidders during a limited period of time (typically 30-50 days) following the execution of the merger agreement. The target company is permitted to exchange confidential information with a potential bidder, subject to the execution of a confidentiality agreement with terms and conditions substantially the same as the terms and conditions of the confidentiality agreement executed by the initial bidder. Any non-public information provided or made available to a competing bidder typically must also be provided or made available to the initial bidder.

Increasingly, go-shops also provide for a bifurcated termination fee – a lower fee payable if the target terminates for a competing bidder who is identified

⁸⁴⁶ In upholding a 3% of equity or transaction value termination fee, Vice Chancellor Parsons wrote in *In re Cogent, Inc. Shareholder Litigation*, 7 A.3d 487, 503 (Del. Ch. 2010): “A termination fee of 3% is generally reasonable.” See *Goodwin v. Live Entm’t, Inc.*, C.A. No. 15765, 1999 WL 64265, at *23 (Del. Ch. Jan. 25, 1999); *Matador*, 729 A.2d at 291 n.15 (discussing authorities).

⁸⁴⁷ *In re Cogent, Inc. Shareholder Litigation*, 7 A.3d 487, 502 (Del. Ch. 2010); *In re Orchid Cellmark Inc. Shareholder Litigation*, C.A. No. 6373-VCN, 2011 Del. Ch. LEXIS 75, at *2 (Del. Ch. May 12, 2011).

⁸⁴⁸ *In re Converge, Inc. Shareholders Litigation*, 2014 WL 6686570 (Del. Ch. Nov. 25, 2014) (Delaware Court of Chancery denied a motion to dismiss a complaint that alleged a Board acted in bad faith (and thus would not have the protection of DGCL § 102(b)(7)) by approving a termination fee equal to 5.55% of the deal’s equity value if triggered during a “go-shop” period and 7% of the deal’s equity value if triggered afterwards, and commented that the potentially preclusive effects of the termination fee structure had to be assessed alongside an expense reimbursement provision in the merger agreement and a convertible bridge loan provided by the buyer that, after giving effect to the convertible bridge loan, would have required a third party to pay 11.6% to 13.1% of the transaction’s equity value to submit a successful topping bid); *Paramount Commc’ns Inc. v. QVC Network Inc.*, 637 A.2d 34 (Del. 1994); see Steven M. Haas and James A. Kennedy, *Delaware Court Upholds Claims Challenging Unreasonable Termination Fee Structure*, INSIGHTS: THE CORPORATE & SECURITIES LAW ADVISOR, Vol. 29, No. 1, Jan. 2015.

⁸⁴⁹ *In re Cogent, Inc. Shareholder Litigation*, 7 A.3d 487, 502 (Del. Ch. 2010); cf. *In re Pennaco Energy, Inc. S’holders Litig.*, 787 A. 2d 691, 702 n.16 (Del. Ch. 2001) (noting that “Delaware cases have tended to use equity value as a benchmark for measuring the termination fee” but adding that “no case has squarely addressed which benchmark is appropriate”).

during the go-shop period and a traditional termination fee if the target terminates for a competing bidder who is identified after the go-shop period ends.⁸⁵⁰

Private equity bidders particularly like go-shop provisions because they allow them to sign up a target without the costs and uncertainties associated with a pre-signing auction. Targets may agree to a go-shop in lieu of an auction because they believe the buyer would be unwilling to bid if the target commenced an auction or because of concerns that an auction might fail to produce a satisfactory transaction, thereby leaving the target with the damaged goods image together possible employee or customer losses. While a go-shop gives the Board an opportunity, with a transaction with the first bidder under contract, to canvass the market for a possibly higher bid and thus to have a basis for claiming that it has satisfied its *Revlon* duties to seek the highest price reasonably available when control of the company is being sold, the bidder can take some comfort that the risk that its bid will be jumped is relatively low.⁸⁵¹

The Delaware courts have long recognized that a pre-signing auction is not the exclusive way for a Board to satisfy its *Revlon* duties and that a post-signing market check can be sufficient. The Chancery Court in *In re Netsmart Technologies* found a post-signing “window-shop” which allowed the target Board to consider only unsolicited third party proposals was not a sufficient market test in the context of a micro-cap company because the Court concluded that a targeted sales effort would be needed to get the attention of potential competing bidders, but found a “go-shop” a reasonable means for a Board to satisfy its *Revlon* duties in the context of a large-cap company in the *In re Lear Corporation Shareholder Litigation*. The *In re Topps Company Shareholders Litigation* produced a colorful Chancery Court validation of a go-shop:

Although a target might desire a longer Go Shop Period or a lower break fee, the deal protections the Topps board agreed to in the Merger Agreement seem to have left reasonable room for an effective post-signing market check. For 40 days, the Topps board could shop like Paris Hilton. Even after the Go Shop Period expired, the Topps board could entertain an unsolicited bid, and, subject to Eisner’s match right, accept a Superior Proposal. The 40-day Go Shop Period and this later right work together, as they allowed interested bidders to talk to Topps and obtain information during the Go Shop Period with the knowledge that if they needed more time to decide whether to make a bid, they could lob in an unsolicited Superior Proposal after the Period expired and resume the process.

⁸⁵⁰ Mark A. Morton & Roxanne L. Houtman, *Go-Shops: Market Check Magic or Mirage?*, Vol. XII Deal Points, Issue 2 (Summer 2007) at 2. See *Berg v. Ellison*, C.A. No. 2949-VCS (Del. Ch. June 12, 2007) (commenting that a go-shop period of only 25 days at a lower breakup fee was not enough time for a new bidder to do due diligence, submit a bid and negotiate a merger agreement, particularly if the initial bidder has a right to match the new bidder’s offer; Stephen I. Glover and Jonathan P. Goodman, *Go Shops: Are They Here to Stay*, 11 No. 6 M&A LAW. 1 (June 2007); see also Guhan Subramanian, *Go-Shops vs. No-Shops in Private Equity Deals: Evidence and Implications*, 63 BUS. LAW. 729 (May 2008).

⁸⁵¹ See Mark A. Morton & Roxanne L. Houtman, *Go-Shops: Market Check Magic or Mirage?*, Vol. XII Deal Points, Issue 2 (Summer 2007) at 2, 7.

2.7.7. Dealing with a Competing Acquiror. Even in the friendly acquisition, a Board's obligations do not cease with the execution of the merger agreement.⁸⁵² If a competing acquiror emerges during the period between the signing of the merger agreement and the stockholder vote thereon with a serious proposal offering greater value to shareholders (usually a higher price), the Board should give it due consideration.⁸⁵³ Generally the same principles that guided consideration of an initial proposal (being adequately informed and undertaking an active and orderly deliberation) will also guide consideration of the competing proposal⁸⁵⁴ prior to the shareholder vote on the merger agreement.⁸⁵⁵

(a) **Fiduciary Outs.** A Board should seek to maximize its flexibility in responding to a competing bidder in the no-shop provision of the merger agreement. It will generally be advisable for the agreement to contain provisions permitting the corporation not only to provide information to a bidder with a superior proposal, but also to negotiate with the bidder, enter into a definitive agreement with the bidder and terminate the existing merger agreement upon the payment of a break-up fee. Without the ability to terminate the agreement, the Board may find, at least under the language of the agreement, that its response will be more limited.⁸⁵⁶ In such

⁸⁵² See e.g., *Emerson Radio Corp. v. Int'l Jensen Inc.*, Nos. 15130, 14992, 1996 WL 483086, at *1 (Del. Ch. 1996) (discussing case where bidding and negotiations continued more than six months after merger agreement signed); see Brian JM Quinn, *Optionality in Merger Agreements*, 35 Del. J. Corp. L. 789 (2010).

⁸⁵³ See *Phelps Dodge Corp. v. Cyprus Amax Minerals Co.*, C.A. Nos. 17383, 17398, 17427, 1999 WL 1054255, at *1 (Del. Ch. Sept. 27, 1999); *ACE Ltd. v. Capital Re Corp.*, 747 A.2d 95, 107-08 (Del. Ch. 1999).

⁸⁵⁴ See *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1282 n.29 (Del. 1988).

⁸⁵⁵ See *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A. 2d 914, 939 n.88 (Del. 2003) (“Merger agreements involve an ownership decision and, therefore, cannot become final without stockholder approval.) Other contracts do not require a fiduciary out clause because they involve business judgments that are within the exclusive province of the board of directors’ power to manage the affairs of the corporation.”); *Cirrus Holding v. Cirrus Ind.*, 794 A.2d 1191, 1193 (Del. Ch. 2001) (“The directors were required to consider all available alternatives in an informed manner until such time as the [stock purchase agreement] was submitted to the stockholders for approval.”); *In re Mobile Communications Corp., Consol. Litigation*, 1991 Del. Ch. LEXIS 4, Fed. Sec. L. Rep. (CCH) P96,558 (Del. Ch. Jan. 18, 1991) (fiduciary out terminated “once an affirmative shareholder vote on the merger occurred” unless the merger agreement provided “for the board to have the power to abandon [the] merger after the shareholders have approved it”).

⁸⁵⁶ See *Smith v. Van Gorkom*, 488 A.2d 858, 888 (Del. 1985) (“Clearly the . . . Board was not ‘free’ to withdraw from its agreement . . . by simply relying on its self-induced failure to have [negotiated a suitable] original agreement.”); *Global Asset Capital, LLC vs. Rubicon US REIT, Inc.*, C.A. No. 5071-VCL (Del. Ch. Nov. 16, 2009) (transcript), available at: http://www.skadden.com/newsletters/Global_Asset_Capital_LLC_v_Rubicon.pdf (In the context of explaining why he granted a temporary restraining order enjoining the target and its affiliates from disclosing any of the contents of a letter of intent or soliciting or entertaining any third-party offers for the duration of the letter of intent, Vice Chancellor Laster wrote: “[I]f parties want to enter into nonbinding letters of intent, that’s fine. They can readily do that by expressly saying that the letter of intent is nonbinding, that by providing that, it will be subject in all respects to future documentation, issues that, at least at this stage, I don’t believe are here. I think this letter of intent is binding . . . [A] no-shop provision, exclusivity provision, in a letter of intent is something that is important. . . . [A]n exclusivity provision or a no-shop provision is a unique right that needs to be protected and is not something that is readily remedied after the fact by money damages. . . . [C]ontracts, in my view, do not have inherent fiduciary outs. People bargain for fiduciary outs because, as our Supreme Court taught in *Van Gorkom*, if you do not get a fiduciary out, you put yourself in a position where you are potentially exposed to contract damages and contract remedies at the same time you may potentially be exposed to other claims. Therefore, it is prudent

circumstances, there may be some doubt as to its ability to negotiate with the bidder or otherwise pursue the bid. This may in turn force the competing bidder to take its bid directly to the shareholders through a tender offer, with a concomitant loss of board control over the process.

Bidders may seek to reduce the Board's flexibility by negotiating for an obligation in the merger agreement to submit the merger agreement to stockholders (also known as a "force the vote" provision) even if the Board subsequently withdraws its recommendation to the stockholders. Such an obligation is now permitted by DGCL § 146. The decision to undertake such submission, however, implicates the Board's fiduciary duties.

Omnicare, Inc v NCS Healthcare, Inc. The Delaware Supreme Court's April 4, 2003 decision in *Omnicare, Inc. v. NCS Healthcare, Inc.*⁸⁵⁷ deals with the interrelationship between a "force the vote" provision in the merger agreement, a voting agreement which essentially obligated a majority of the voting power of the target company's shares to vote in favor of a merger and the absence of a "fiduciary termination right" in the merger agreement that would have enabled the board of directors to back out of the deal before the merger vote if a better deal comes along.

The decision in *Omnicare* considered a challenge to a pending merger agreement between NCS Healthcare, Inc. and Genesis Health Ventures, Inc. Prior to entering into the Genesis merger agreement, the NCS directors were aware that Omnicare was interested in acquiring NCS. In fact, Omnicare had previously submitted proposals to acquire NCS in a pre-packaged bankruptcy transaction. NCS, however, entered into an exclusivity agreement with Genesis in early July 2002. When Omnicare learned from other sources that NCS was negotiating with Genesis and that the parties were close to a deal, it submitted an offer that would have paid NCS stockholders \$3.00 cash per share, which was more than three times the value of the \$0.90 per share, all stock, proposal NCS was then negotiating with Genesis. Omnicare's proposal was conditioned upon negotiation of a definitive merger agreement, obtaining required third party consents, and completing its due diligence. The exclusivity agreement with Genesis, however, prevented NCS from discussing the proposal with Omnicare.

When NCS disclosed the Omnicare offer to Genesis, Genesis responded by enhancing its offer. The enhanced terms included an increase in the exchange ratio so that each NCS share would be exchanged for Genesis stock then valued at \$1.60 per share. But Genesis also insisted that NCS approve and sign the merger agreement as well as approve and secure the voting agreements by midnight the next day, before the exclusivity agreement with Genesis was scheduled to expire. On July 28, 2002, the NCS directors approved the Genesis merger agreement prior to the expiration of Genesis's deadline.

to put in a fiduciary out, because otherwise, you put yourself in an untenable position. That doesn't mean that contracts are options where boards are concerned. Quite the contrary. And the fact that equity will enjoin certain contractual provisions that have been entered into in breach of fiduciary duty does not give someone carte blanche to walk as a fiduciary. . . . I don't regard fiduciary outs as inherent in every agreement."). *But see also Paramount Commc'ns Inc. v. QVC Network Inc.*, 637 A.2d 34, 51 (Del. 1994) (noting that a board cannot "contract away" its fiduciary duties); *ACE*, 747 A.2d at 107-08.

⁸⁵⁷ *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A. 2d 914, 917 (Del. 2003).

The merger agreement contained a “force-the-vote” provision authorized by the DGCL, which required the agreement to be submitted to a vote of NCS’s stockholders, even if its Board later withdrew its recommendation of the merger (which the NCS Board later did). In addition, two NCS director-stockholders who collectively held a majority of the voting power, but approximately 20% of the equity of NCS, agreed unconditionally and at the insistence of Genesis to vote all of their shares in favor of the Genesis merger. The NCS Board authorized NCS to become a party to the voting agreements and granted approval under § 203 of the Delaware General Corporation Law, in order to permit Genesis to become an interested stockholder for purposes of that statute. The “force-the-vote” provision and the voting agreements, which together operated to ensure consummation of the Genesis merger, were not subject to fiduciary outs.

The Court of Chancery’s Decision in Omnicare. The Court of Chancery declined to enjoin the NCS/Genesis merger. In its decision, the Court emphasized that NCS was a financially troubled company that had been operating on the edge of insolvency for some time. The Court also determined that the NCS Board was disinterested and independent of Genesis and was fully informed. The Vice Chancellor further emphasized his view that the NCS Board had determined in good faith that it would be better for NCS and its stockholders to accept the fully-negotiated deal with Genesis, notwithstanding the lock up provisions, rather than risk losing the Genesis offer and also risk that negotiations with Omnicare over the terms of a definitive merger agreement could fail.

The Supreme Court Majority Opinion in Omnicare. On appeal, the Supreme Court of Delaware accepted the Court of Chancery’s finding that the NCS directors were disinterested and independent and assumed “arguendo” that they exercised due care in approving the Genesis merger. Nonetheless, the majority held that the “force-the-vote” provision in the merger agreement and the voting agreements operated in tandem to irrevocably “lock up” the merger and to preclude the NCS Board from exercising its ongoing obligation to consider and accept higher bids. Because the merger agreement did not contain a fiduciary out, the Delaware Supreme Court held that the Genesis merger agreement was both preclusive and coercive and, therefore, invalid under *Unocal Corp. v. Mesa Petroleum Co.*:⁸⁵⁸

The record reflects that the defensive devices employed by the NCS board are preclusive and coercive in the sense that they accomplished a *fait accompli*. In this case, despite the fact that the NCS board has withdrawn its recommendation for the Genesis transaction and recommended its rejection by the stockholders, the deal protection devices approved by the NCS board operated in concert to have a preclusive and coercive effect. Those tripartite defensive measures – the Section 251(c) provision, the voting agreements, and the absence of an effective fiduciary out clause – made it “mathematically impossible” and “realistically unattainable” for the Omnicare transaction or any other proposal to succeed, no matter how superior the proposal.⁸⁵⁹

⁸⁵⁸ *Unocal Corp. v. Mesa Petrol. Co.*, 493 A.2d 946, 949 (Del. 1985).

⁸⁵⁹ *Omnicare*, 818 A.2d at 936.

As an alternative basis for its conclusion, the majority held that under the circumstances the NCS Board did not have authority under Delaware law to completely “lock up” the transaction because the defensive measures “completely prevented the board from discharging its fiduciary responsibilities to the minority stockholders when Omnicare presented its superior transaction.”⁸⁶⁰ In so holding, the Court relied upon its decision in *Paramount Communications Inc. v. QVC Networks Inc.*, in which the Court held that “[t]o the extent that a [merger] contract, or a provision thereof, purports to require a board to act or not act in such a fashion as to limit the exercise of fiduciary duties, it is invalid and unenforceable.”⁸⁶¹

The Dissents in Omnicare. Chief Justice Veasey and Justice Steele wrote separate dissents. Both believed that the NCS Board was disinterested and independent and acted with due care and in good faith – observations with which the majority did not necessarily disagree. The dissenters articulated their view that it was “unwise” to have a bright-line rule prohibiting absolute lock ups because in some circumstances an absolute lock up might be the only way to secure a transaction that is in the best interests of the stockholders. The dissenters would have affirmed on the basis that the NCS Board’s decision was protected by the business judgment rule. Both Chief Justice Veasey and Justice Steele expressed a hope that the majority’s decision “will be interpreted narrowly and will be seen as *sui generis*.”⁸⁶²

Impact of the Omnicare Decision. The *Omnicare* decision has several important ramifications with regard to the approval of deal protection measures in the merger context.

First, the decision can be read to suggest a bright-line rule that a “force-the-vote” provision cannot be utilized in connection with voting agreements locking up over 50% of the stockholder vote unless the Board of the target corporation retains for itself a fiduciary out that would enable it to terminate the merger agreement in favor of a superior proposal. It is worth noting that the decision does not preclude – but rather seems to confirm the validity of – combining a “force-the-vote” provision with a voting agreement locking up a majority of the stock so long as the Board retains an effective fiduciary out. More uncertain is the extent to which the rule announced in *Omnicare* might apply to circumstances in which a merger agreement includes a “force-the-vote” provision along with a fiduciary termination out and contemplates either an option for the buyer to purchase a majority block of stock or a contractual right of the buyer to receive some or all of the upside received by a majority block if a superior proposal is accepted. While neither structure would disable the Board from continuing to exercise its fiduciary obligations to consider alternative bids, arguments could be made that such a structure is coercive or preclusive, depending upon the particular circumstances.

The *Omnicare* decision also does not expressly preclude coupling a “force-the-vote” provision with a voting agreement locking up less than a majority block of stock, even if the Board does not retain a fiduciary termination out. Caution would be warranted, however, if a buyer were to request a “force-the-vote” provision without a fiduciary termination out and seek to couple such a provision with a voting agreement affecting a substantial block of stock, as that form of deal protection could potentially implicate the same concerns expressed by the majority

⁸⁶⁰ *Id.* at 936.

⁸⁶¹ *Paramount Commc’ns Inc. v. QVC Network Inc.*, 637 A.2d 34, 51 (Del. 1994).

⁸⁶² *Omnicare*, 818 A.2d at 946.

in *Omnicare*. Moreover, existing case law and commentary make clear that a Board must retain its ability to make full disclosure to stockholders if a merger agreement contains a “force-the-vote” provision and does not provide the board with a fiduciary termination right.

The extent to which the bright-line rule announced in *Omnicare* may be applicable to other factual circumstances remains to be seen. Powerful arguments can be made, for example, that a similar prohibition should not apply to circumstances in which the majority stockholder vote is obtained by written consents executed after the merger agreement is approved and signed. Likewise, it is doubtful that a similar prohibition should apply to a merger with a majority stockholder who has expressed an intention to veto any transaction in which it is not the buyer.

Second, the majority’s decision confirms that *Unocal*’s enhanced judicial scrutiny is applicable to a Delaware court’s evaluation of deal protection measures designed to protect a merger agreement. Where Board-implemented defensive measures require judicial review under *Unocal*, the initial burden is on the defendant directors to demonstrate that they had reasonable grounds for believing that a threat to corporate policy and effectiveness existed and that they took action in response to the threat that was neither coercive nor preclusive and that was within a range of reasonable responses to the threat perceived. Prior to *Omnicare*, there appeared to be a split of authority in the Delaware Court of Chancery as to whether deal protection measures in the merger context should be evaluated under *Unocal*. Although the dissenters questioned whether *Unocal* should be the appropriate standard of review, the majority decision confirms that *Unocal* applies to judicial review of deal protection measures.

Orman v Cullman. A year after *Omnicare*, the Chancery Court in *Orman v. Cullman (General Cigar)*,⁸⁶³ upheld a merger agreement in which majority stockholders with high vote stock agreed to vote their shares pro rata in accordance with public stockholders and the majority stockholders also agreed not to vote in favor of another transaction for eighteen months following termination. The Chancery Court found that such a transaction was not coercive because there was no penalty to public stockholders for voting against the transaction.

In *Orman*, the Court focused on whether the combined effect of the provisions was coercive and upheld the deal protection devices as not being coercive. In this case, the acquiror obtained a voting agreement from stockholders owning a majority of the voting stock of the target entity. The target had two classes of stock (class A and class B), and the approval of the class A stockholders voting as a separate class was required. The voting agreement required the subject stockholders to vote in favor of the transaction, to not sell their shares and to vote their class B shares against any alternative acquisition for a period of up to eighteen months following the termination of the merger agreement. However, the voting agreement also contained a “mirrored voting” provision that required the stockholders subject to voting agreements to vote their shares of class A common stock in accordance with the vote of the other class A stockholders in connection with the vote to approve the transaction. Despite the “mirrored voting” concession with respect to a vote on the proposed transaction, there was an absolute obligation on the parties to the voting agreement to vote against a competing transaction. The terms of the merger agreement allowed the Board of the target to consider alternative proposals if the special committee of the Board determined the proposal was bona fide and more favorable

⁸⁶³ *Orman v. Cullman*, C.A. No. 18039, 2004 Del. Ch. LEXIS 150, at *32 (Del. Ch. Oct. 20, 2004).

than the existing transaction. The Board was also permitted to withdraw its recommendation of the transaction if the Board concluded it was required to do so in order to fulfill its fiduciary duties. However, the merger agreement did contain a “force the vote” provision requiring the target to convene a special meeting of stockholders to consider the transaction even if the board withdrew its recommendation.

In upholding the deal protection provisions, the *Orman* Court, using reasoning similar to the dissent in *Omnicare*, concluded that the voting agreement and the eighteen month tail provision following the termination of the merger agreement did not undermine the effect that the class A stockholders had the right to vote on a deal on the merits. Thus, unlike in *Omnicare*, the deal protection measures did not result in “*a fait accompli*” where the result was predetermined regardless of the public shareholders’ actions. The combination of the shareholders’ ability to reject the transaction and the ability of the Board to alter the recommendation resulted in the Court concluding that “as a matter of law [that] the deal protection mechanisms present here were not impermissibly coercive.”⁸⁶⁴ The plaintiff did not argue that the arrangement was “preclusive.”

Omnicare and *Orman* emphasize the risk of having deal protection measures that do not contain an effective “fiduciary out” or which would combine a “force the vote” provision with voting agreements that irrevocably lock up a substantial percentage of the stockholder vote. Although under *Omnicare*, voting agreements locking up sufficient voting power to approve a merger are problematic, locking up less than 50% of the voting power could also be an issue in particular circumstances.⁸⁶⁵

Optima International of Miami, Inc v WCI Steel, Inc. In *Optima International of Miami, Inc. v. WCI Steel, Inc.*, the Court declined to enjoin a merger that had been approved by the Board of WCI Steel Inc. and adopted by its stockholders later that same day by written consent pursuant to a merger agreement permitting the acquirer to terminate the agreement if stockholder approval was not obtained within 24 hours.⁸⁶⁶

In rejecting Plaintiffs’ argument that the stockholder vote was a form of a lockup that either exceeded the Board’s power or resulted in a breach of its fiduciary duties in violation of *Omnicare*, the Court explained:

But a stockholder vote is not like the lockup in *Omnicare*. First, it’s really not my place to note this, but *Omnicare* is of questionable continued vitality.

⁸⁶⁴ *Id.* at *32.

⁸⁶⁵ Compare *ACE Ltd. v. Capital Re Corp.*, 747 A.2d 95, 98 (Del. Ch. 1999) (noting that acquiror’s ownership of 12.3% of target’s stock and voting agreements with respect to another 33.5%, gave acquiror, as a “virtual certainty,” the votes to consummate the merger even if a materially more valuable transaction became available) with *In re IXC Commc’ns, Inc. S’holders Litig.*, C.A. Nos. 17324, 17334, 1999 Del. Ch. LEXIS 210, at *24 (Del. Ch. Oct. 27, 1999) (stating, in reference to a transaction where an independent majority of the target’s stockholders owning nearly 60% of the target’s shares could freely vote for or against the merger, “[a]most locked up’ does not mean ‘locked up,’ and ‘scant power’ may mean less power, but it decidedly does not mean ‘no power,’” and finding that the voting agreement did not “have the purpose or effect of disenfranchising [the] remaining majority of [stock]holders”).

⁸⁶⁶ C.A. No. 3833-VCL (Del. Ch. June 27, 2008).

Secondly, the stockholder vote here was part of an executed contract that the board recommended after deciding it was better for stockholders to take Severstal's lower-but-more-certain bid than Optima's higher-but-more-risky bid. In this context, the board's discussion reflects an awareness that the company had severe liquidity problems. Moreover, it was completely unclear that Optima would be able to consummate any transaction. Therefore, the stockholder vote, although quickly taken, was simply the next step in the transaction as contemplated by the statute. Nothing in the DGCL requires any particular period of time between a board's authorization of a merger agreement and the necessary stockholder vote. And I don't see how the board's agreement to proceed as it did could result in a finding of a breach of duty.⁸⁶⁷

In re OPENLANE, Inc Shareholders Litigation. *Omnicare* was further explained and limited by the Court of Chancery in *In re OPENLANE, Inc. Shareholders Litigation*,⁸⁶⁸ wherein the Court refused to enjoin an all-cash merger transaction negotiated by an actively engaged and independent Board, despite the fact that the merger agreement did not contain a fairness opinion or a fiduciary out, and the transaction was effectively locked up by the execution of written consents by a majority of the stockholders on the day following execution of the merger agreement. In the context of a thinly-traded company in which 68.5% of the stock was held by a sixteen-person group of management and directors, and in anticipation of declining business, the Board engaged an investment banker to contact a limited number of strategic buyers and negotiated with three potential strategic buyers, but did not undertake a broad auction or contact any possible financial buyers.

In the ensuing shareholder litigation, the plaintiffs attacked the Board's decision to contact only three potential buyers, the lack of a fairness opinion, the lack of a post-signing market check, and the lack of any provision in the merger agreement permitting the directors to terminate it if their fiduciary duties so required. In rejecting those challenges, Vice Chancellor Noble effectively held that *Revlon* duties apply in a small company setting, but in recognizing that a fiduciary duty analysis is contextual and takes into account the resources available to the corporation, commented:

This raises a question as to when a small public company, like OPENLANE, would want to pay a financial advisor to undertake an extensive market check or provide a fairness opinion. The fact that a company is small, however, does not modify core fiduciary duties and would not seem to alter the analysis, unless its board, like OPENLANE's, was well-versed in the company's business. In other words, small companies do not get a pass just for being small. Where, however, a small company is managed by a board with an impeccable knowledge of the company's business, the Court may consider the size of the company in determining what is reasonable and appropriate.⁸⁶⁹

⁸⁶⁷ *Optima*, C.A. No. 3833-VCL.

⁸⁶⁸ *In re OPENLANE, Inc. S'holders Litig.*, C.A. No. 6849-VCN, 2011 WL 4599662, at *1 (Del. Ch. Sept. 30, 2011).

⁸⁶⁹ *In re OPENLANE, Inc. S'holders Litig.*, 2011 WL 4599662 (Del. Ch. Sept. 30, 2011) (Noble, V.C.).

The Vice Chancellor reiterated that Delaware does not impose a mandatory checklist of merger features, but cautioned that where “a board fails to employ any traditional value maximization tool, such as an auction, a broad market check, or a go-shop provision, that board must possess an impeccable knowledge of the company’s business for the Court to determine that it acted reasonably.” *Omnicare* was distinguished on the grounds that the votes were not strictly “locked up” pursuant to a voting agreement, although “after the Board approved the Merger Agreement, the holders of a majority of shares quickly provided consents.”

NACCO Industries, Inc v Applica Incorporated. “No-shop” and other deal protection provisions will be enforced by Delaware courts if they are negotiated after a proper process and are not unduly restrictive under the standards discussed above. In *NACCO Industries, Inc. v. Applica Incorporated*,⁸⁷⁰ NACCO (the acquirer under a merger agreement) brought claims against Applica (the target company) for breach of the merger agreement’s “no-shop” and “prompt notice” provisions. NACCO also sued hedge funds managed by Herbert Management Corporation (collectively “*Harbinger*”), which made a topping bid after the merger agreement with NACCO was executed, for common law fraud and tortious interference with contract.

NACCO’s complaint alleged that while NACCO and Applica were negotiating a merger agreement, Applica insiders provided confidential information to principals at the Harbinger hedge funds, which were then considering their own bid for Applica. During this period, Harbinger amassed a substantial stake in Applica (which ultimately reached 40%), but reported on its Schedule 13D filings that its purchases were for “investment,” thereby disclaiming any intent to control the company. After NACCO signed the merger agreement, communications between Harbinger and Applica management about a topping bid continued. Eventually, Harbinger amended its Schedule 13D disclosures and made a topping bid for Applica, which then terminated the NACCO merger agreement. After a bidding contest with NACCO, Harbinger succeeded in acquiring the company.

In refusing to dismiss damages claims by NACCO arising out of its failed attempt to acquire Applica, Vice Chancellor Laster largely denied defendants’ motion to dismiss. As to the contract claims, the Court reaffirmed the utility of “no-shop” and other deal protection provisions, holding that “[i]t is critical to [Delaware] law that those bargained-for rights be enforced,” including by a post-closing damages remedy in an appropriate case. Good faith compliance with such provisions may require a party to “regularly pick up the phone” to communicate with a merger partner about a potential overbid, particularly because “in the context of a topping bid, days matter.” Noting that the no-shop clause was not limited to merely soliciting a competing bid, and that the “prompt notice” clause required Applica to use “commercially reasonable efforts” to inform NACCO of any alternative bids and negotiations, the Vice Chancellor had “no difficulty inferring” that Applica’s alleged “radio silen[ce]” about the Harbinger initiative may have failed to meet the contractual standard.

The Vice Chancellor also upheld NACCO’s common law fraud claims against Harbinger based on the alleged inaccuracy of Harbinger’s Schedule 13D disclosures about its plans regarding Applica. The Vice Chancellor dismissed Harbinger’s contention that all claims related to Schedule 13D filings belong in federal court, holding instead that a “Delaware entity engaged

⁸⁷⁰ 997 A.2d 1, 6 (Del. Ch. 2009).

in fraud”—even if in an SEC filing required by the 1934 Act—“should expect that it can be held to account in the Delaware courts.” The Vice Chancellor noted that while the federal courts have exclusive jurisdiction over violations of the 1934 Act, the Delaware Supreme Court has held that statutory remedies under the 1934 Act are “intended to coexist with claims based on state law and not preempt them.” The Vice Chancellor emphasized that NACCO was not seeking state law enforcement of federal disclosure requirements, but rather had alleged that Harbinger’s statements in its Schedule 13D and 13G filings were fraudulent under state law without regard to whether those statements complied with federal law. The Court then ruled that NACCO had adequately pleaded that Harbinger’s disclosure of a mere “investment” intent was false or misleading, squarely rejecting the argument that “one need not disclose any intent other than an investment intent until one actually makes a bid.” In this respect, the *NACCO* decision highlights the importance of accurate Schedule 13D disclosures by greater-than-5% beneficial owners that are seeking or may seek to acquire a public company and raises the possibility of monetary liability to a competing bidder if faulty Schedule 13D disclosures are seen as providing an unfair advantage in the competition to acquire the company.

While *NACCO* was a fact-specific decision on motion to dismiss, the case shows the risks inherent in attempting to top an existing merger agreement with typical deal protection provisions. *NACCO* emphasizes that parties to merger agreements must respect no-shop and notification provisions in good faith or risk after-the-fact litigation, with uncertain damages exposure, from the acquiring party under an existing merger agreement.

(b) Level Playing Field. If a bidding contest ensues, a Board cannot treat bidders differently unless such treatment enhances shareholder interests. As the Court in *Barkan* stated, “[w]hen multiple bidders are competing for control, this concern for fairness [to shareholders] forbids directors from using defensive mechanisms to thwart an auction or to favor one bidder over another.”⁸⁷¹ In *Macmillan*, however, the Court stated that the purpose of enhancing shareholder interests “does not preclude differing treatment of bidders when necessary to advance those interests. Variables may occur which necessitate such treatment.”⁸⁷² The *Macmillan* Court cited a “coercive ‘two-tiered’ bust-up tender offer” as one example of a situation that could justify disparate treatment of bidders.⁸⁷³

In all-cash transactions disparate treatment is unlikely to be permitted. In the context of keeping bidders on a level playing field, the Court in *Revlon* stated that:

Favoritism for a white knight to the total exclusion of a hostile bidder might be justifiable when the latter’s offer adversely affects shareholder interests, but when bidders make relatively similar offers, or dissolution of the company becomes inevitable, the directors cannot fulfill their enhanced Unocal duties by playing favorites with the contending factions.⁸⁷⁴

⁸⁷¹ *Barkan v. Amsted Indus., Inc.*, 567 A.2d 1279, 1286-87 (Del. 1989); see also *Paramount Commc’ns Inc. v. QVC Network Inc.*, 637 A.2d 34, 45 (Del. 1994).

⁸⁷² *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1286-87 (Del. 1988).

⁸⁷³ *Id.* at 1287 n.38.

⁸⁷⁴ *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 184 (Del. 1986).

The Court in *QVC* restated this concept and applied the *Unocal* test in stating that in the event a corporation treats bidders differently, “the trial court must first examine whether the directors properly perceived that shareholder interests were enhanced. In any event the board’s action must be reasonable in relation to the advantage sought to be achieved, or conversely, to the threat which a particular bid allegedly poses to stockholder interests.”⁸⁷⁵

(c) Match Rights. A buyer which provides a fiduciary out to the target typically seeks to include in the merger agreement a provision giving it an opportunity to match any third party offer which the target’s Board concludes is a superior proposal entitling the target Board to terminate the merger agreement. In *Berg v. Ellison*, Vice Chancellor Strine commented that a match right might deter other bidders, but not unacceptably:

[A]ny kind of matching right is clearly going to chill anything, despite the fact that on multiple occasions, as reflected in Delaware case law and other things, people won out over a match right or topped a match right three times before the original bidder, in a foolish fit of indiscipline, raised their bid to an unsustainable level, and the other bidders went back and giggled and said “Well, you won it now but at 25 percent more than you should have paid.”⁸⁷⁶

Match rights have been described in Delaware Chancery Court opinions, but have not been considered preclusive or otherwise inappropriate.⁸⁷⁷

(d) Top-Up Options. In a negotiated two-step acquisition, the buyer negotiates the terms of both the first step tender offer and the follow-up merger to acquire any target shares not acquired in the tender offer before commencing the tender offer.⁸⁷⁸ If the buyer owns at least 90% of the target’s shares after the tender offer, the buyer’s Board can adopt a resolution merging the target into the buyer and file it with the applicable Secretary of State to effect the merger without holding a shareholder meeting, which obviates the cost and delay of holding a meeting and soliciting proxies therefor.⁸⁷⁹ To address the risk that after the tender offer the buyer will not own 90% of the target’s shares, it had become “commonplace in two-step tender offer deals” for the merger agreement to grant to a buyer, who after shares tendered in the tender offer were purchased, would own not less than a majority of the outstanding stock, the option to purchase after closing the tender offer for the tender offer price enough shares to cross the 90% threshold.⁸⁸⁰ Top-up options per se generally do not raise fiduciary duty issues.⁸⁸¹

⁸⁷⁵ *QVC*, 637 A.2d at 45 (quoting *Macmillan*, 559 A.2d at 1288).

⁸⁷⁶ C.A. No. 2949-VCS (Del. Ch. June 12, 2007).

⁸⁷⁷ See, e.g., *Novell I*, C.A. No. 6032-VCN, 2013 Del. Ch. LEXIS 1 (Del. Ch. Jan. 3, 2013); *In re Topps Co. S’holder Litig.*, 926 A.2d 58, 60 (Del. Ch. 2007); *In re Cogent, Inc. Shareholder Litigation*, 7 A.3d 487, 492 (Del. Ch. 2010).

⁸⁷⁸ Mark A. Morton & John F. Grossbauer, *Top-Up Options and Short Form Mergers*, VII DEAL POINTS – THE NEWSLETTER OF THE COMMITTEE ON NEGOTIATED ACQUISITIONS, 2 (Spring 2002), available at http://www.potteranderson.com/media/publication/171_MAM_20JFG_20Top-Up_20Options_20and_20Short_20Form_20Mergers_20_20Apr_202002_20Deal_20Points0.pdf.

⁸⁷⁹ See TBOC § 10.006 and DGCL § 253.

⁸⁸⁰ *In re Cogent, Inc. Shareholder Litigation*, 7 A.3d 487, 492 (Del. Ch. 2010), citing “Am. Bar Ass’n Mergers & Acqs. Mkt. Subcomm., 2009 Strategic Buyer/Public Targets M&A Deal Points Study, at 106 (Sept. 10,

DGCL § 251 has been amended to eliminate the stockholder vote requirement for the back-end merger in a two-step acquisition if (i) after the first-step tender offer, the acquirer owns or a depository has received at least the number of shares that would otherwise need to be voted for the merger to be approved under the DGCL and the target's charter, (ii) the target's charter does not provide otherwise, (iii) the target's shares are publicly traded (or held of record by more than 2,000 stockholders), (iv) the parties expressly provide in their merger agreement that the second-step, cash-out merger may be governed by DGCL § 251(h), and that the merger will be effectuated "as soon as practicable" if the acquirer's tender offer is successfully consummated, (v) the tender offer was for any and all shares of the target's outstanding stock that would otherwise be entitled to vote on the merger and which are not owned by the target, the acquirer, or any of their subsidiaries, (vi) the acquirer actually merges with the target following the tender offer pursuant to the merger agreement, and (vii) the stockholders who are cashed out in the merger receive the same consideration that was paid to the stockholders who tendered their shares.⁸⁸² DGCL § 251(h) may eliminate the use of top-up options in many situations.

2009) (reporting that 94% of two-step tender offer cash deals involved a top-up option in 2007 compared to 67% in 2005/2006)." See Mark A. Morton & John F. Grossbauer, *Top-Up Options and Short Form Mergers*, VII DEAL POINTS – THE NEWSLETTER OF THE COMMITTEE ON NEGOTIATED ACQUISITIONS, 2 (Spring 2002), available at http://www.potteranderson.com/media/publication/171_MAM_20JFG_20Top-Up_20Options_20and_20Short_20Form_20Mergers_20_20Apr_202002_20Deal_20Points0.pdf, in which the authors state "for every 1% that a bidder's tender offer falls short of 90%, a "top-up" option will require the target to issue that number of shares which is equal to 10% of its outstanding stock prior to the tender offer," and stress that in negotiating a top-up option, the Board should understand the mechanics and implications of the option, and whether the target has sufficient shares authorized. Edward B. Micheletti & Sarah T. Runnells, *The Rise and (Apparent) Fall of the Top-Up Option "Appraisal Dilution" Claim*, 15 No. 1 M&A LAW. 9 (Jan. 2011). Because of the dilution that could result from the exercise of a top-up option and to address challenges based on its effect on stockholder appraisal rights, merger agreements typically provide that the exercise of the top-up option will not be given effect in valuing the stock in any statutory appraisal action.

⁸⁸¹ *In Re Comverge, Inc. Shareholders Litigation*, Consol. C.A. No. 7368-VCP (Del. Ch. Nov. 25, 2014).

⁸⁸² DGCL § 251(h) provides as follows:

(h) Notwithstanding the requirements of subsection (c) of this section, unless expressly required by its certificate of incorporation, no vote of stockholders of a constituent corporation whose shares are listed on a national securities exchange or held of record by more than 2,000 holders immediately prior to the execution of the agreement of merger by such constituent corporation shall be necessary to authorize a merger if:

(1) The agreement of merger expressly:

- a. Permits or requires such merger to be effected under this subsection; and
- b. Provides that such merger shall be effected as soon as practicable following the consummation of the offer referred to in paragraph (h)(2) of this section if such merger is effected under this subsection;

(2) A corporation consummates a tender or exchange offer for any and all of the outstanding stock of such constituent corporation on the terms provided in such agreement of merger that, absent this subsection, would be entitled to vote on the adoption or rejection of the agreement of merger; provided, however, that such offer may exclude stock of such constituent corporation that is owned at the commencement of such offer by:

- a. Such constituent corporation;
- b. The corporation making such offer;
- c. Any person that owns, directly or indirectly, all of the outstanding stock of the corporation making such offer; or

(e) Best Value. In seeking to obtain the “best value” reasonably available, the Delaware Supreme Court has stated *that the “best value” does not necessarily mean the highest price.*

In Citron,⁸⁸³ Fairchild was the subject of a bidding contest between two competing bidders, Schlumberger and Gould.⁸⁸⁴ The Fairchild board had an all cash offer of \$66 per share from Schlumberger, and a two-tier offer of \$70 per share from Gould, with the terms of the valuation of the back-end of Gould’s offer left undefined.⁸⁸⁵ The board was also informed by its experts that a transaction with Schlumberger raised substantially less antitrust concern than a transaction with Gould. The board accepted Schlumberger’s offer. In upholding the agreement between Fairchild and Schlumberger, the Court stated that Gould’s failure to present a firm unconditional offer precluded an auction.⁸⁸⁶ The Court also stated that Fairchild had a duty to consider “a host of factors,” including “the nature and timing of the offer,” and “its legality,

d. Any direct or indirect wholly-owned subsidiary of any of the foregoing;

(3) Following the consummation of the offer referred to in paragraph (h)(2) of this section, the stock irrevocably accepted for purchase or exchange pursuant to such offer and received by the depository prior to expiration of such offer, plus the stock otherwise owned by the consummating corporation equals at least such percentage of the stock, and of each class or series thereof, of such constituent corporation that, absent this subsection, would be required to adopt the agreement of merger by this chapter and by the certificate of incorporation of such constituent corporation;

(4) The corporation consummating the offer referred to in paragraph (h)(2) of this section merges with or into such constituent corporation pursuant to such agreement; and

(5) Each outstanding share of each class or series of stock of the constituent corporation that is the subject of and not irrevocably accepted for purchase or exchange in the offer referred to in paragraph (h)(2) of this section is to be converted in such merger into, or into the right to receive, the same amount and kind of cash, property, rights or securities to be paid for shares of such class or series of stock of such constituent corporation irrevocably accepted for purchase or exchange in such offer.

(6) As used in this section only, the term:

a. “Consummates” (and with correlative meaning, “consummation” and “consummating”) means irrevocably accepts for purchase or exchange stock tendered pursuant to a tender or exchange offer;

b. “Depository” means an agent, including a depository, appointed to facilitate consummation of the offer referred to in paragraph (h)(2) of this section;

c. “Person” means any individual, corporation, partnership, limited liability company, unincorporated association or other entity; and

d. “Received” (solely for purposes of paragraph (h)(3) of this section) means physical receipt of a stock certificate in the case of certificated shares and transfer into the depository’s account, or an agent’s message being received by the depository, in the case of uncertificated shares.

If an agreement of merger is adopted without the vote of stockholders of a corporation pursuant to this subsection, the secretary or assistant secretary of the surviving corporation shall certify on the agreement that the agreement has been adopted pursuant to this subsection and that the conditions specified in this subsection (other than the condition listed in paragraph (h)(4) of this section) have been satisfied; provided that such certification on the agreement shall not be required if a certificate of merger is filed in lieu of filing the agreement. The agreement so adopted and certified shall then be filed and shall become effective, in accordance with § 103 of this title. Such filing shall constitute a representation by the person who executes the agreement that the facts stated in the certificate remain true immediately prior to such filing.

⁸⁸³ *Citron v. Fairchild Camera and Instrument Corp.*, 569 A.2d 53, 54 (Del. 1989).

⁸⁸⁴ *Id.* at 54.

⁸⁸⁵ *Id.*

⁸⁸⁶ *Id.* at 68-69.

feasibility and effect on the corporation and its stockholders,” in deciding whether to accept or reject Gould’s claim.⁸⁸⁷ Nevertheless, the *Citron* Court specifically found that Fairchild “studiously endeavored to avoid ‘playing favorites’” between the two bidders.⁸⁸⁸

A decision not to pursue a higher price, however, necessarily involves uncertainty, the resolution of which depends on a court’s view of the facts and circumstances specific to the case. In *In re Lukens Incorporated Shareholders Litigation*,⁸⁸⁹ the Court sustained a board decision to sell to one bidder, notwithstanding the known possibility that a “carve up” of the business between the two bidders could result in incremental stockholder value. The Court placed great weight on the approval of the transaction by the stockholders after disclosure of the carve-up possibility.⁸⁹⁰

In the final analysis, in many cases, the board may not know that it has obtained the best value reasonably available until after the merger agreement is signed and competing bids are no longer proposed. In several cases, the Delaware courts have found as evidence that the directors obtained the best value reasonably available the fact that no other bidders came forward with a competing offer once the transaction was public knowledge.⁸⁹¹

2.7.8. Postponement of Stockholder Meeting to Vote on Merger. In *Mercier v. Inter-Tel (Delaware), Inc.*, the Delaware Court of Chancery held that a disinterested Special Committee may postpone for a short duration a stockholders’ meeting called to approve the sale of the company because the Committee knew that if not postponed the merger would be voted down.⁸⁹² In *Inter-Tel*, the Court held that well-motivated, independent directors may reschedule an imminent special meeting at which the stockholders are to consider a merger when the directors:

- (1) believe that the merger is in the best interests of the stockholders;
- (2) know that if the meeting proceeds the stockholders will vote down the merger;
- (3) reasonably fear that in the wake of the merger’s rejection, the acquiror will walk away from the deal and the corporation’s stock price will plummet;
- (4) want more time to communicate with and provide information to the stockholders before the stockholders vote on the merger and risk the irrevocable loss of the pending offer;

⁸⁸⁷ *Id.* at 68.

⁸⁸⁸ *Id.*

⁸⁸⁹ 757 A.2d 720, 738 (Del. Ch. 1999).

⁸⁹⁰ *Lukens*, 757 A.2d at 738.

⁸⁹¹ See, e.g., *Barkan v. Amstad Indus., Inc.*, 567 A.2d 1279, 1287 (Del. 1989) (noting that “when it is widely known that some change of control is in the offing and no rival bids are forthcoming over an extended period of time, that fact is supportive of the board’s decision to proceed”); *Goodwin v. Live Entm’t, Inc.*, C.A. No. 15765, 1999 WL 64265, at *23 (Del. Ch. Jan. 25, 1999) (“Given that no draconian defenses were in place and that the merger was consummated three months after its public announcement, the fact that no bidders came forward is important evidence supporting the reasonableness of the Board’s decision.”); *Matador Capital Mgmt. Corp. v. BRC Holdings, Inc.*, 729 A.2d 280, 293 (Del. Ch. 1998) (failure of any other bidder to make a bid within one month after the transaction was announced “is evidence that the directors, in fact, obtained the highest and best transaction reasonably available”).

⁸⁹² 929 A.2d 786, 787 (Del. Ch. 2007).

(5) reschedule the meeting within a reasonable time period; and (6) do not preclude or coerce the stockholders from freely deciding to reject the merger.⁸⁹³

In so holding, the Court distinguished *Blasius Industries, Inc. v. Atlas Corp.*⁸⁹⁴ and other cases wherein directors manipulate the election process for the purposes of entrenching themselves and for which the Board's action will be upheld only where it can show "compelling justification." Since director elections and board entrenchment were not at issue, the Court applied a *Unocal* "reasonableness" standard of review that places the burden on the Board to identify the proper corporate objectives served by their actions and demonstrate that their actions were reasonable in relationship to their legitimate objectives and did not preclude stockholders from exercising their right to vote or coerce them into voting a particular way.⁸⁹⁵

Following the determination that Inter-Tel's Special Committee had satisfied the *Unocal*-style requirements and even though it concluded that the *Blasius* standard would not apply because he found that the Special Committee's non-preclusive, non-coercive action did not have the primary purpose of disenfranchisement (in part because none of the Committee members had been promised any position following the merger and all expected to lose their Board seats), the Court found that the independent directors had met the *Blasius* "compelling justification" standard by demonstrating that: (i) stockholders were about to reject a third-party merger proposal that the independent directors believed to be in their best interest; (ii) information useful to the stockholders' decision-making process had not been adequately considered or had not yet been publicly disclosed; and (iii) if the stockholders had voted no, the acquiror would have walked away without making a higher bid and the opportunity to receive that bid would have been lost.

2.7.9. Responses to Hostile Takeover Attempts. Shareholder rights plans ("*Rights Plans*")⁸⁹⁶ and state anti-takeover laws, which developed in response to abusive takeover tactics and inadequate bids, have become a central feature of most major corporations' takeover preparedness.⁸⁹⁷ For example, over 2,300 companies have adopted Rights Plans.

Rights Plans and state anti-takeover laws⁸⁹⁸ do not interfere with negotiated transactions, nor do they preclude unsolicited takeovers. They are intended to cause bidders to deal with the target's Board and ultimately extract a higher acquisition premium than would otherwise have

⁸⁹³ *Id.*

⁸⁹⁴ 564 A.2d 651, 652 (Del. Ch. 1988); *cf.* J. Travis Laster & Michelle D. Morris, *How to Avoid a Collision Between the Delaware Annual Meeting Requirement and the Federal Proxy Rules*, 10 Del. L. Rev. 213 (2008).

⁸⁹⁵ *See supra* notes 695-698.

⁸⁹⁶ *See Appendix E – Shareholder Rights Plans.*

⁸⁹⁷ *See infra* notes 987-998 and related text. State corporation statutes intended to restrain some of the abuses associated with hostile takeovers were validated by the United States Supreme Court in *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69, 72 (1987). *See Amanda Acquisition Corp. v. Universal Foods Corp.*, 877 F.2d 496, 505-09 (7th Cir. 1989), *cert. denied*, 493 U.S. 955 (1989) (upholding Wisconsin's 3-year moratorium statute); Byron F. Egan and Bradley L. Whitlock, *State Shareholder Protection Statutes*, University of Texas 11th Annual Conference on Securities Regulation and Business Law Problems (Mar. 10, 1989).

⁸⁹⁸ *See, e.g.*, TBOC §§ 21.601-21.610; DGCL § 203; and *infra* note 987-998 and related text.

been the case. If a bidder takes action that triggers the Rights Plan or the anti-takeover laws, however, dramatic changes in the position of the bidder can result.

In a negotiated transaction the Board can let down the defensive screen afforded by a Rights Plan or state anti-takeover law to allow the transaction to proceed. Doing so, however, requires strict compliance with the terms of the Rights Plan and applicable statutes, as well as compliance with the directors' fiduciary duties.

2.8. Oppression of Minority Shareholders.

2.8.1. Introduction. Shareholder oppression has not been recognized as a separate cause of action by the Supreme Courts of either Delaware or Texas. In its June 20, 2014 decision in *Ritchie v. Rupe*,⁸⁹⁹ the Texas Supreme Court held that minority shareholder oppression is not a separate common law cause of action, as there are adequate remedies for oppressive conduct in the case law relating to breaches of fiduciary duties and limited the statutory remedies therefor to a receivership.⁹⁰⁰

Under the internal affairs doctrine, a Texas court should apply Texas law to a minority shareholder oppression claim involving a Texas corporation and should apply Delaware law to an oppression claim involving a Delaware corporation.⁹⁰¹ In Delaware, it is generally understood that there is no separate cause of action for minority stockholder oppression, although

⁸⁹⁹ 443 S.W.3d 856 (Tex. 2014).

⁹⁰⁰ In Texas prior to the Supreme Court's decision in *Ritchie v. Rupe*, shareholder oppression has been frequently alleged in disputes among minority and controlling shareholders. Charles Henry Still, *Shareholder Oppression Actions in Texas*, Texas Bar CLE, Ninth Annual Advanced Business Law Course (Oct. 13-14, 2011). A few Texas Courts of Appeal have held that oppressive conduct of a controlling shareholder is actionable as a separate cause of action irrespective of whether the conduct also constitutes a breach of fiduciary duty. *Bulacher v. Enowa*, No. 3:10-CV-156-M, 2010 WL 1135958, at *1 (N.D. Tex. March 23, 2010); *Fanning v. Barrington Condominium Assoc., Inc.*, No. 04-09-00752-CV, 2010 WL 1984070, at *1 (Tex. App.—San Antonio Jan. 21, 2010, no pet.); *Gibney v. Culver*, No. 13-06-112-CV, 2008 WL 1822767, at *1 (Tex. App.—Corpus Christi Apr. 24, 2008, pet. denied); *Redmon v. Griffith*, 202 S.W.3d 225, 230 (Tex. App.—Tyler 2006), *reh'g overruled*, (May 2, 2006); *Willis v. Bydalek*, 997 S.W.2d 798, 799 (Tex. App.—Houston [1st Dist.] 1999, pet. denied) *disapproved of by Ritchie v. Rupe*, 443 S.W.3d 857 (Tex. 2014); *Davis v. Sheerin*, 754 S.W.2d 375, 377 (Tex. App.—Houston [1st Dist.] 1988, writ denied), *overruled by Ritchie v. Rupe*, 443 S.W.3d 856 (Tex. 2014); *Duncan v. Lichtenberger*, 671 S.W.2d 948, 949 (Tex. App.—Fort Worth 1984, writ ref'd n.r.e.); *Patton v. Nicholas*, 279 S.W.2d 848, 849 (Tex. 1955); *Hammond v. Hammond*, 216 S.W.2d 630, 633 (Tex. Civ. App.—Fort Worth 1949, no writ).

⁹⁰¹ See TBOC § 9.251 (A foreign entity's "activity concerning the entity's internal affairs" does not constitute transacting business in Texas and, thus, is governed by the laws of the foreign state); *Id.* at 1.01 (purpose of the code is to rearrange and consolidate preexisting law); TBCA art. 8.02 ("[T]he laws of the jurisdiction of incorporation of a foreign corporation shall govern (1) the internal affairs of the foreign corporation, including but not limited to the rights, powers, and duties of its board of directors and shareholders and matters relating to its shares, and (2) the liability, if any, of shareholders of the foreign corporation for the debts, liabilities, and obligations of the foreign corporation for which they are not otherwise liable by statute or agreement."); *supra* notes 264-270 and related text (discussing the applicability of these statutes). See also *Warren v. Warren Equip. Co.*, 189 S.W.3d 324, 329 (Tex. App.—Eastland 2006, no pet.) (applying Delaware law in dismissing a shareholder oppression claim filed against Delaware corporation); *Riblet Products Corp. v. Nagy*, 683 A.2d 37, 38 (Del. 1996) (applying Delaware law to a shareholder oppression claim filed against a Delaware corporation with its principal place of business in Indiana). See *supra* notes 264-269 and related text.

two unpublished Chancery Court opinions contain dicta suggesting that stockholder oppression may under certain circumstances be a separate cause of action⁹⁰² and numerous cases have found that oppressive conduct of a controlling shareholder constitutes a breach of the fiduciary duty of loyalty.⁹⁰³

2.8.2. Texas.

(a) Ritchie v Rupe. In *Ritchie v. Rupe* the Texas Supreme Court limited the remedies available for claims of “minority shareholder oppression,” which are essentially acts of a majority shareholder group that are harmful to a minority shareholder without necessarily harming the corporation itself.⁹⁰⁴ At issue in the case was the decision of the Board of a closely held Texas corporation to decline to meet with persons who might be interested in buying the stock of an 18% shareholder.⁹⁰⁵ The court of appeals originally ruled that the Board’s decision constituted shareholder oppression because such corporate actions constructively prohibited the shareholder from performing the necessary activities to sell her stock, thereby substantially defeating the shareholder’s general reasonable expectations. However, the Supreme Court overturned that decision, holding that for claims of minority shareholder oppression the sole remedy available under Texas law is a statutory receivership.

The Court also emphasized that common law fiduciary duties, as articulated in *Gearhart Indus., Inc. v. Smith Intern., Inc.*,⁹⁰⁶ are still the appropriate lens through which to evaluate the conduct of directors of Texas corporations. The Supreme Court explained that the robustness of those fiduciary duty claims was one of its reasons for holding that there is not separate cause of action of shareholder oppression. As such, the scope and applicability of those fiduciary duties are crucial to understanding which potential causes of action still remain for minority shareholders in a closely held Texas corporation, post-*Ritchie v. Rupe*.

⁹⁰² See *Gagliardi v. Trifoods Intl*, 683 A.2d 1049, 1051 (Del. Ch. 1996) (assuming that “for purposes of this motion, without deciding, that under some circumstances” Delaware fiduciary duty law recognizes a cause of action for oppression of minority shareholders); *Litle v. Waters*, C.A. No. 12155, 1992 WL 25758, at *327 (Del. Ch. Feb. 11, 1992) (“since I am not aware of a Delaware case that has found oppressive behavior, I look to decisions [of other states] that have found oppression for guidance”). In *Gagliardi* and *Litle*, both Courts of Chancery only analyzed the plaintiffs’ claims under shareholder oppression theories in order to rule on the pending motions to dismiss the claim, and recognized that Delaware case law does not provide a basis for a cause of action of minority shareholders. *Id.* Further the sections of the Courts of Chancery’s opinions addressing a cause of action for oppression of minority shareholders are unpublished opinions, indicating their lack of value for precedential purposes. As such, despite *Gagliardi* and *Litle*, Delaware law is clear in declining to adopt a cause of action for shareholder oppression.

⁹⁰³ See infra notes 979-982 and related text.

⁹⁰⁴ *Ritchie v. Rupe*, 443 S.W.3d 856, 873 (Tex. 2014).

⁹⁰⁵ In *Ritchie v. Rupe*, 339 S.W.3d 275 (Tex. App.–Dallas, 2011), *rev’d* by 443 S.W.3d 856 (Tex. 2014), the court of appeals ruled that the Board’s conduct did constitute shareholder oppression, even though the Board had made an informed business decision based on advice of counsel that nothing good could come to the corporation of such meetings and that there would be thorny issues regarding what information should be shared and attendant securities law liabilities. The court of appeals held that the Board’s refusal to meet with prospective purchasers in this case was determined to be oppression because it made the shareholder’s ability to sell her stock “impossible,” which the court said was a reasonable expectation of the shareholder.

⁹⁰⁶ 741 F.2d 707, 723–24 (5th Cir. 1984).

The Fifth Circuit stated in *Gearhart* that under Texas law “[t]hree broad duties stem from the fiduciary status of corporate directors; namely the duties of obedience, loyalty, and due care,” and commented that (i) the duty of obedience requires a director to avoid committing *ultra vires* acts, i.e., acts beyond the scope of the authority of the corporation as defined by its articles of incorporation or the laws of the state of incorporation, (ii) the duty of loyalty dictates that a director must act in good faith and must not allow his or her personal interests to prevail over the interests of the corporation, and (iii) the duty of due care requires that a director must handle his or her corporate duties with such care as an ordinarily prudent man would use under similar circumstances. Officers owe essentially the same fiduciary duties as directors. While it held that Texas law embraces a strong deference to the uncorrupted business judgment of directors, *Gearhart* also stated that the Texas business judgment rule is not applicable to claims for breach of loyalty.⁹⁰⁷

The duty of loyalty dictates that a director must act in good faith and not allow his or her personal interest to prevail over that of the corporation.⁹⁰⁸ Whether there exists a personal interest by a director will be a question of fact.⁹⁰⁹ The good faith of a director will be determined based on whether the director acted with an intent to confer a benefit to the corporation as a whole, or rather, to the director individually, their family, friends, or others.⁹¹⁰ In Texas “good faith” has been held to mean a state of mind consisting of (1) honesty of belief or purpose, (2) faithfulness to one’s duty or obligation, or (3) absence of intent to defraud or to seek unconscionable advantage.

In general, under the fiduciary duty of loyalty a director will not be permitted to derive a personal profit or advantage at the expense of the corporation and must act solely with an eye to the best interest of the corporation, unhampered by any pecuniary interest of his own. The court in *Gearhart* summarized Texas law with respect to the question of whether a director is “interested” in the context of self-dealing transactions:

A director is considered “interested” if he or she (1) makes a personal profit from a transaction by dealing with the corporation or usurps a corporate opportunity . . . ; (2) buys or sells assets of the corporation . . . ; (3) transacts business in his director’s capacity with a second corporation of which he is also a director or significantly financially associated . . . ; or (4) transacts business in his director’s capacity with a family member.⁹¹¹

In *Ritchie v. Rupe*, the Supreme Court elaborated that:

[T]he duty of loyalty that officers and directors owe to the corporation specifically prohibits them from misapplying corporate assets for their personal gain or wrongfully diverting corporate opportunities to themselves. *See, e.g., Holloway*,

⁹⁰⁷ *Id.* at 723 n. 9 (noting that the business judgment rule is only a defense to the duty of care).

⁹⁰⁸ *Gearhart Indus., Inc. v. Smith Int’l*, 741 F.2d 707, 719 (5th Cir. 1984).

⁹⁰⁹ *Int’l Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 578 (Tex. 1963).

⁹¹⁰ *Id.* at 577 (indicating that good faith conduct requires a showing that the directors had “an intent to confer a benefit to the corporation”).

⁹¹¹ *Gearhart*, 741 F.2d at 719-20.

368 S.W.2d at 576 (“A corporate fiduciary is under obligation not to usurp corporate opportunities for personal gain, and equity will hold him accountable to the corporation for his profits if he does so.”); *Dunagan v. Bushey*, 152 Tex. 630, 636, 263 S.W.2d 148, 152 (1953) (“The directors of a corporation stand in a fiduciary relationship to the corporation and its stockholders, and they are without authority to act as such in a matter in which a director’s interest is adverse to that of the corporation. The directors are not permitted to appropriate the property of the corporation to their benefit, nor should they permit others to do so.”); *see also* Tex. Bus. Orgs. Code § 7.001(c)(1), (3). Like most of the actions we have already discussed, these types of actions may be redressed through a derivative action, or through a direct action brought by the corporation, for breach of fiduciary duty.⁹¹²

Therefore, if the directors or officers of a closely-held corporation are shown to have violated their fiduciary duties, such as by obtaining an improper personal benefit through the use of corporate assets or opportunities, then minority shareholders can still recover their damages in a suit for breach of the fiduciary duty of loyalty and, under some circumstances, punitive damages. The recovery for a breach of the fiduciary duty of loyalty should be as great as for a claim for shareholder oppression under pre-*Ritchie v. Rupe* case law.

(b) Texas Statutes. The Tex. Corp. Stats. do not define “oppression” or “oppressive conduct.” However, both the TBCA⁹¹³ and the TBOC provide for the appointment of a receiver for the assets and business of a corporation by a district court where the acts of the directors or those in control of the corporation have been oppressive to conserve the assets and business of the corporation if other remedies are inadequate. Specifically, a court with proper jurisdiction may appoint a receivership for the purpose of rehabilitating a corporation upon establishing that (1) the entity is insolvent or in imminent danger of insolvency, (2) the governing persons are deadlocked in the management of the corporation’s affairs and such deadlock is threatening or causing irreparable injury to the corporation, (3) the actions of its governing persons are “illegal, oppressive, or fraudulent,” (4) the corporation’s property is “being misapplied or wasted,” or (5) the corporation’s shareholders are deadlocked and have failed to elect successor governing persons for at least two years.⁹¹⁴ While the purpose of a rehabilitative receivership to remedy the harm which threatens the corporation, TBOC § 11.405(a)(3) provides that a court may convert a rehabilitative receivership into a liquidating receivership if it finds that a feasible plan for remedying the condition requiring appointment of the receiver has not been presented within one year of the initial appointment.

⁹¹² *Ritchie v. Rupe*, 443 S.W.3d at 887.

⁹¹³ Under TBCA art. 7.05, a receiver may be appointed for the assets and business of a corporation “but only if all other remedies available either at law or in equity, including the appointment of a receiver for specific assets of the corporation, are determined by the court to be inadequate...” and “in an action by a shareholder when it is established...that the acts of the directors or those in control of the corporation are illegal, *oppressive* or fraudulent.” [emphasis added]

The Comment of Bar Committee to TBCA art. 7.05 states: “The appointment of a receiver to rehabilitate a corporation is available only if the less harsh remedy of a receivership for specific assets is inadequate. Such a receivership is designed to be purely a temporary measure.”

⁹¹⁴ TBOC § 11.404.

Judicial rehabilitative receivership usually occurs when circumstances exist which requires an appointment of a receiver to “conserve the property and business to avoid damage to interested parties.”⁹¹⁵ A receivership is to be used only when other remedies are inadequate and is a drastic remedy used in extreme circumstances. There are very few Texas cases which discuss judicial rehabilitative receivership. In the few cases that do discuss receivership, the cases involve divorced couples who are the opposite parties in the lawsuit. Again, the court usually stresses other remedies rather than receivership:

[A] court of equity may properly take jurisdiction to wind up the affairs of a corporation and sell and distribute its assets at the suit of a minority shareholder on the ground of dissensions among shareholders, but that it is only an extremely aggravated condition of affairs that will warrant such drastic action and that the court will follow such a procedure only when it reasonably appears that the dissensions are of such nature as to imperil the business of the corporation to a serious extent and that there is no reasonable likelihood of protecting the rights of the minority shareholder by some method short of winding up the affairs of the corporation.⁹¹⁶

Although minority shareholder oppression is no longer a separate common law cause of action for damages in Texas following *Ritchie v. Rupe*, TBOC § 11.404(a)(1)(C) provides that, in an action brought by a shareholder, a court may appoint a rehabilitative (but not a liquidating⁹¹⁷) receiver for the corporation’s property and business if it is established that “the actions of the governing persons are illegal, oppressive or fraudulent.” Although in *Ritchie v. Rupe* the Supreme Court commented that a receivership is a harsh remedy to be used sparingly, the Court confirmed that a receivership is still an available remedy that could be pursued to prevent a controlling shareholder’s conduct from further injuring the corporation or minority shareholders. The Supreme Court’s definition in *Ritchie v. Rupe* of “oppressive” conduct for which a rehabilitative receivership is available would encompass those types of breaches of the duty of loyalty:

Considering the language and context of the statute, we have identified at least three characteristics of “actions” that the statute refers to as “oppressive”: (1) the actions justify the harsh, temporary remedy of a rehabilitative receivership; (2) the actions are severe and create exigent circumstances; and (3) the actions are inconsistent with the directors’ duty to exercise their honest business judgment for the benefit of the corporation. The term’s common meaning and its usage in other statutes add a fourth characteristic: the actions involve an unjust exercise or abuse of power that harms the rights or interests of persons subject to the actor’s authority and disserves the purpose for which the power is authorized. Actions that uniformly affect all shareholders typically will not satisfy this aspect of the

⁹¹⁵ *Fanning v. Barrington Condominium Assoc., Inc.*, No. 2009-CI-10922, 2010 WL 1984070, at *1 (Tex. App.—San Antonio, Mar. 26, 2010, no pet.).

⁹¹⁶ *Hammond v. Hammond*, 216 S.W.2d, 630, 633 (Tex. Civ. App.—Fort Worth 1949, no writ).

⁹¹⁷ 443 S.W.3d at 872 n.20. The Court noted that the statute under which the plaintiff asserted oppressive conduct authorized only a rehabilitative-receivership, and not a liquidating-receivership. *See also* TBOC §§ 11.404-.405; TBCA §§ 7.05-.06.

term's meaning because, collectively, the shareholders of a business are not at the mercy of the business's directors.⁹¹⁸

Under both the TBOC and the TBCA, the Supreme Court in *Ritchie v. Rupe* explained the requirements a plaintiff would have to meet to have a receiver appointed as follows:

The term “oppressive” . . . occurs within a statute that authorizes courts to appoint a receiver to take over a corporation's governance, displacing those who are otherwise legally empowered to manage the corporation. Within this context, two aspects of this receivership statute are particularly relevant. First, both former *article 7.05* and current *section 11.404* are not limited to closely held corporations. See former *art. 7.05*; *Tex. Bus. Orgs. Code § 11.404*. The Legislature has adopted a single standard for rehabilitative receivership based on oppressive actions that applies to all corporations (and, under the current statute, any “domestic entity” [which would include a limited partnership]) without regard to the number of its shareholders or the marketability of its shares.

* * *

Second, the statute places significant restrictions on the availability of a receivership: (1) the receivership must be “necessary . . . to conserve the assets and business of the corporation and to avoid damage to parties at interest,” (2) “all other requirements of law [must be] complied with,” and (3) “all other remedies available either at law or in equity” must be “inadequate.” Former *art. 7.05(A)* (emphasis added); see also *Tex. Bus. Orgs. Code § 11.404(b)*. These requirements demonstrate the Legislature's intent that receivership--which replaces the managers the shareholders chose with the courts' chosen managers--is a “harsh” remedy that is not readily available. See *Balias, 748 S.W.2d at 257*.⁹¹⁹

While the Supreme Court in *Ritchie v. Rupe* held that damages and a court-ordered buyout are not available as remedies for minority shareholder oppression and indicated that a rehabilitative receivership under TBOC Section 11.404(a)(1)(C) is a harsh remedy to be used sparingly, the Supreme Court did indicate that a rehabilitative receivership is still an available remedy.

The demise of minority shareholder oppression as a separate cause of action for damages leaves as viable remedies for a director or officer's self-dealing and similar malfeasance (i) fiduciary duty damage claims for a breach of the fiduciary duty of loyalty and (ii) a receivership of the corporation. Contrary to some interpretations, the *Ritchie v. Rupe* decision leaves vibrant claims for breach of the fiduciary duty of loyalty and viable remedies for such breaches if appropriate facts can be established.

(c) Shareholder Oppression Prior to *Ritchie v. Rupe*. Before the Supreme Court's decision in *Ritchie v. Rupe*, the Texas Supreme Court had never addressed the doctrine of

⁹¹⁸ *Ritchie v. Rupe*, 443 S.W.3d at 870.

⁹¹⁹ *Id.* at 867.

shareholder oppression. However, there were a few decisions from lower Texas appellate court holding that shareholder oppression was a separate cause of action.⁹²⁰ All of the Texas cases in which shareholder oppression was found involved small corporations with very few shareholders. The majority of these cases featured corporations with only two shareholders, while some have as many as four shareholders.

Courts considering minority shareholder oppression cases recited deference to director business judgment, although not as vigorously as other Texas cases.⁹²¹ In the Dallas court of appeals' *Ritchie v. Rupe* decision, director compliance with fiduciary duties did not deter the Court from finding shareholder oppression.⁹²² Remedies available to address shareholder oppression included court-ordered buyout of minority shares, injunctive relief, and, if other remedies are inadequate, a receivership.

Prior to the Supreme Court's decision in *Ritchie v. Rupe*, the leading Texas court of appeals case regarding shareholder oppression was *Davis v. Sheerin*, which defined "shareholder oppression" as either:

(i) Majority shareholders' conduct that substantially defeats the minority's expectations that, objectively viewed, were both reasonable under the circumstances and central to the minority shareholder's decision to join the venture; or

(ii) Burdensome, harsh, or wrongful conduct; a lack of probity and fair dealing in the company's affairs to the prejudice of some members; or a visible departure from the standards of fair dealing and a violation of fair play on which each shareholder is entitled to rely.⁹²³

In *Davis v. Sheerin*, a Texas corporation had two shareholders, and both of these shareholders were also directors and officers. The majority shareholder ("Davis") was the president of the company and managed the daily operations while the minority shareholder ("Sheerin") was merely an investor and did not work at the corporation. Sheerin initially sued because Davis refused to allow Sheerin access to the books and records of the corporation. Davis claimed that Sheerin had relinquished his holdings in the corporation. The jury found that Sheerin never gave up his shares in the corporation, and also found that Davis attempted to purchase Sheerin's shares on multiple occasions. Further, the jury found that (i) the Davis and his wife attempted to deprive Sheerin of his shares; (ii) Davis and his wife breached their fiduciary duties to Sheerin by (a) receiving "informal dividends" through profit sharing plan contributions which excluded Sheerin and (b) wasting corporate funds with legal fees to defend the suit.⁹²⁴ On appeal, the main issue was the trial court's order that Davis and his wife "buy-out" Sheerin's shares in the corporation at fair market value as determined by a jury. The Court of

⁹²⁰ See *supra* note 900 (identifying Texas cases addressing shareholder oppression).

⁹²¹ *Gearhart Indus., Inc. v. Smith Int'l, Inc.*, 741 F.2d 707, 723 n.9 (5th Cir. 1984); *Cates v. Sparkman*, 11 S.W. 846, 848 (Tex. 1889). See *supra* notes 271-316 and related text (discussing the application of the business judgment rule under Texas law).

⁹²² *Ritchie v. Rupe*, 339 S.W.3d 275, 280 (Tex. App.—Dallas 2011, *rev'd* by 443 S.W.3d 856 (Tex. 2014)).

⁹²³ *Davis v. Sheerin*, 754 S.W.2d 375, 377 (Tex. App.—Houston [1st Dist.] 1988, writ denied), *overruled by Ritchie v. Rupe*, 443 S.W.3d 856 (Tex. 2014).

⁹²⁴ *Davis v. Sheerin*, 754 S.W.2d at 381.

Appeals upheld the buy-out because “Texas courts, under their general equity power, may decree a ‘buy-out’ in an appropriate case where less harsh remedies are inadequate to protect the rights of the parties.”⁹²⁵ In addition, because “oppressive conduct” was not defined in the TBCA, the *Davis* court adopted the definition of shareholder oppression from other jurisdictions, as cited above.

In *Davis*, the court explained that a “narrow definition would be inappropriate”⁹²⁶ and held that the individual facts of the case would determine “whether the acts complained of serve to frustrate the legitimate expectations of the minority shareholders, or whether the acts are of such severity as to warrant the requested relief.”⁹²⁷

Other Texas courts have found oppression in the following conduct attributed to controlling shareholders:

- Using corporate funds for personal expenses without board of directors approval and refusing access to corporate financial statements (*Redmon v. Griffith*).⁹²⁸
- Diluting and depriving a minority shareholder of his value in the corporation by prepaying consultant fees in an attempt to artificially lower the company’s income performance and attempting to entice the minority shareholder to sell his shares at a fraction of the true market value price (*Bulacher v. Enowa*).⁹²⁹
- “Malicious suppression of dividends” while the corporation is making profits was found to be “a wrong akin to breach of trust” (i.e., a breach of fiduciary duty) in *Patton v. Nicholas*, where the controlling, majority shareholder “juggled” the books “so as arbitrarily to indicate low profits,”⁹³⁰ although *Patton* is referenced in other opinions as an early shareholder oppression case. The jury in *Patton* found that the majority shareholder had maliciously lowered the value of the two minority shareholders’ stock, and the court concluded that the majority shareholder “intended to eliminate the respondents from every connection with the business, and at an unfair sacrifice on their part.”⁹³¹

Other decisions found no shareholder oppression:

- In *Willis v. Bydalek*,⁹³² the minority shareholder was a salaried, at-will employee who was “willfully locked out” of the corporation (as the majority shareholder literally changed the locks on the business, and took over management of the business), and

⁹²⁵ *Id.* at 380.

⁹²⁶ *Id.* at 381.

⁹²⁷ *Id.*

⁹²⁸ *Redmon v. Griffith*, 202 S.W.3d 225, 234 (Tex. App.—Tyler 2006, pet. denied), *reh’g overruled*, (May 2, 2006).

⁹²⁹ *Bulacher v. Enowa*, No. 3:10-CV-156-M, 2010 WL 1135958, at *1 (N.D. Tex. March 23, 2010).

⁹³⁰ *Patton v. Nicholas*, 279 S.W.2d 848, 853 (Tex. 1955).

⁹³¹ *Id.* at 584.

⁹³² *Willis v. Bydalek*, 997 S.W.2d 798, 801 (Tex. App.—Houston [1st Dist] 1999, pet. denied).

no longer received a salary for management of the business. The jury at trial found that there was a wrongful lock out, but the Court of Appeals refused to find that a wrongful lock out alone, or the simple firing of an at-will employee, was enough for shareholder oppression. There must be other factors, such as breach of fiduciary duty or the withholding of dividends, along with the firing of the minority shareholder to constitute possible shareholder oppression. Further, the *Willis* court emphasized that “courts must exercise caution in determining what shows oppressive conduct.”⁹³³

- In *Gibney v. Culver*,⁹³⁴ oppression was not found because (1) the denied request to inspect books and records had not stated a proper purpose and (2) the executive compensation complained of was neither excessive nor unreasonable.

The remedies for shareholder oppression prior to *Ritchie v. Rupe* included:

(i) Equitable Remedy. Judicial-ordered buy-out of the minority shareholder’s shares and interest at its fair market value⁹³⁵ has been held to be an appropriate remedy for shareholder oppression (*Davis v. Sheerin* and *Ritchie v. Rupe*). Also, in a suit involving two minority shareholders against the remaining majority shareholder, the minority shareholders received the amount of funds that they originally invested in the corporation (*Duncan v. Lichtenberger*).⁹³⁶

(ii) Injunctive Relief. The Texas Supreme Court in *Patton v. Nicholas* held that injunctive relief was proper where the majority shareholder prevented dividends and required the corporation to pay the two minority shareholders a reasonable dividend at that time and in the future, holding that injunctive relief rather than appointment of a receiver.⁹³⁷

There was no set standard to determine whether or not shareholder oppression has occurred.⁹³⁸ These definitions are so vague that a leading law professor advocate of shareholder oppression as a cause of action even concludes that the “precise contours” of the shareholder oppression doctrine are “fuzzy at best.”⁹³⁹ Appellate court opinions suggested that oppression could be found where there has been: (i) use of corporate assets for the benefit of the controlling shareholders, particularly where there has been no proper board of directors approval; (ii) malicious suppression of dividends or payment of dividends disproportionate to stock ownership, often coupled with excessive salaries and employee benefit plan contributions that discriminate against a minority shareholder; (iv) termination of employment, particularly where the employee

⁹³³ *Willis v. Bydalek*, 997 S.W.2d at 801.

⁹³⁴ *Gibney v. Culver*, No. 13-06-112-CV, 2008 WL 1822767, at *1 (Tex. App.—Corpus Christi Apr. 24, 2008, pet. denied). (in which the court found that there was no shareholder oppression because there was no evidence that the minority shareholder properly requested access to the books and records).

⁹³⁵ Fair market value has been determined by the courts as what a current, willing purchaser would pay for the shares or the minority shareholder’s percentage of the corporation’s overall value. *Pueblo Bancorporation v. Lindoe, Inc.*, 63 P. 3d 353, 362 (Colo. 2003).

⁹³⁶ *Duncan v. Lichtenberger*, 671 S.W.2d 948, 953 (Tex.App.—Fort Worth 1984, writ ref’d n.r.e.).

⁹³⁷ *Patton v. Nicholas*, 279 S.W.2d 848, 853 (Tex. 1955).

⁹³⁸ *Id.* at 382.

⁹³⁹ D. Moll, *Majority Rule (Still) Isn’t What It Used to Be* (2008), originally published at 63 Tex. B.J. 434 (2000).

was dependent on his job for a return on his investment and the job was a reason for making the investment; and (v) wrongful denial of access to corporate books and records.

Trial and appellate courts in Texas were more likely to find shareholder oppression in small closely-held corporations with only two or three shareholders,⁹⁴⁰ although there is no case law “expressly limiting it to such a context.”⁹⁴¹ Below is a summary of the elements and examples of court holdings which either found shareholder oppression, or found that the facts did not support a cause of action of shareholder oppression.

(d) Relationship to Fiduciary Duties. Texas courts that have been hesitant to recognize and apply a shareholder oppression cause of action to the facts before them have instead turned to the fiduciaries duties owed to shareholders as a whole by corporate officers as a source of relief for plaintiffs.⁹⁴² In *Faour v. Faour*, the Texarkana Court of Appeals modified a trial court judgment by deleting any recovery for damages of breach of fiduciary duties, holding that the only bases in liability were breaches of fiduciary duties the corporate officer owed to the shareholders collectively, i.e. the corporation, and thus could not provide a basis to relief to the plaintiff shareholder individually.⁹⁴³ The *Faour* court noted that while a corporate shareholder may have an individual action for wrongs done to him where the wrongdoer violates a duty owed directly by him to the shareholder, this principle is not an exception to the general rule that corporate officers only owe duties to the corporation, but rather is a recognition that a shareholder may sue for violation of his individual rights, regardless of whether the corporation also has a cause of action.⁹⁴⁴ In *Faour*, the court determined that the plaintiffs’ claim was more accurately for corporate mismanagement and loss of stock value, wrongs to the shareholders as a whole, rather than for malicious suppression of dividends as the plaintiff claimed.⁹⁴⁵ As a result, the plaintiff’s direct claim for damages was improper.⁹⁴⁶ Instead of expanding the notion of shareholder oppression that has been accepted by other Texas Courts of Appeal, the *Faour* court turned to traditional fiduciary duties to provide a remedy for the plaintiff.⁹⁴⁷ This case is not alone; instead, Texas courts have frequently shown that oppression cases are properly labeled fiduciary duty cases.⁹⁴⁸

⁹⁴⁰ *Davis v. Sheerin*, 754 S.W.2d at 381.

⁹⁴¹ *Redmon v. Griffith*, 202 S.W.3d 225, 234 (Tex. App.—Tyler 2006, pet. denied), *reh’g overruled*, (May 2, 2006).

⁹⁴² See *infra* notes 943-948 and related text (discussing such cases).

⁹⁴³ 789 S.W.2d 620, 622 (Tex. App.—Texarkana 1990, writ denied).

⁹⁴⁴ *Id.*

⁹⁴⁵ *Id.*

⁹⁴⁶ *Id.*

⁹⁴⁷ *Id.*

⁹⁴⁸ See, e.g., *Morgan v. Box*, 449 S.W.2d 499, 502 (Tex. App.—Dallas 1969, no writ) (analyzing the plaintiffs’ claim for breach of the duty of loyalty in light of evidence that defendants’ “sought to abscond with the corporate property . . . and dissipate its assets and wreck its business”). See also *Allen v. Devon Energy Holdings, L.L.C. F/K/A Chief Holdings, L.L.C. and Trevor Rees-Jones*, 367 S.W.3d 355, 365 (Tex. App.—Houston [1st Dist.] 2012, pet granted) (case settled in 2013 while writ of error pending), in which Allen alleged that Chief and Trevor Rees-Jones, Chief’s manager and majority owner, fraudulently induced him to redeem his interest two years before the company sold for almost 20 times the redemption sales price to Devon Energy Production Company, L.P. The defense focused on disclaimers and release provisions in the

redemption agreement, which it contended barred Allen's fraud claims by negating reliance or materiality as a matter of law. The Court of Appeals held that the redemption agreement did not bar Allen's claims, and that fact issues existed as to fraud and the existence of a fiduciary relationship, in reversing the trial court's summary judgment for the defense and for such purpose assuming the correctness of the facts alleged by Allen below (applying the doctrine of fiduciary duty instead of shareholder oppression and noting "Allen cites no case allowing conduct that is . . . in breach of a fiduciary duty to be the basis of a shareholder oppression claim").

Allen and Rees-Jones served together as partners at a prominent Dallas law firm. Allen was an oil and gas transactions lawyer, and Rees-Jones was a bankruptcy lawyer before leaving the firm to go into the oil and gas business. Allen was one of Chief's early investors, and relied on investment advice from Rees-Jones. In November 2003, Rees-Jones decided to redeem the minority equity interests in Chief. He sent to the minority members a letter explaining the reasons for and terms of the redemption offer, to which he attached (1) an independent valuation firm's opinion on Chief's market value and (2) an appraisal of Chief's existing gas reserves and future drilling prospects. The valuation report included discounts for the sale of a minority interest and for lack of marketability. The letter also included Rees-Jones's pessimistic assessment of a number of facts and events that could negatively impact Chief's value in the future. The redemption proposal languished for seven months until June 2004 when Rees-Jones notified the minority members that Chief was ready to proceed with the redemption. Three of the minority members (including Allen) accepted the redemption offer, and four others chose to retain their interests. There were positive developments in the Barnett Shale area where Chief operated and within Chief in the seven months between the November 2003 offer and the June 2004 redemption, and Allen asserts that these events, which Allen claimed were not disclosed to him and would have materially impacted his decision to redeem his interest.

Chief provided Allen with a written redemption agreement for the first time in June 2004, and "insisted" that the contract be signed by the end of the month. The parties did not exchange drafts, and Allen stated that he had only three days to review the agreement before signing because, as he was on vacation for much of the time.

The redemption agreement contained several release clauses which are discussed below, including an "independent investigation" paragraph, a general "mutual release," and a merger clause which defendants claimed barred Allen's fraud claims negating reliance or materiality as a matter of law. The "independent investigation" paragraph provided that (1) Allen based his decision to sell on his independent due diligence, expertise, and the advice of his own engineering and economic consultants; (2) the appraisal and the reserve analysis were estimates and other professionals might provide different estimates; (3) events subsequent to the reports might "have a positive or negative impact on the value" of Chief; (4) Allen was given the opportunity to discuss the reports and obtain any additional information from Chief's employees as well as the valuation firm and the reserve engineer; and (5) the redemption price was based on the reports regardless of whether those reports reflected the actual value and regardless of any subsequent change in value since the reports. The independent investigation paragraph also included mutual releases "from any claims that might arise as a result of any determination that the value of [Chief] . . . was more or less than" the agreed redemption price at the time of the closing.

In a separate paragraph entitled "mutual releases" each party released the other from all claims that "they had or have arising from, based upon, relating to, or in connection with the formation, operation, management, dissolution and liquidation of [Chief] or the redemption of" Allen's interest in Chief, except for claims for breach of the redemption agreement or breach of the note associated with the redemption agreement. Another paragraph contained a "merger clause" stating that the redemption agreement "supersedes all prior agreements and undertakings, whether oral or written, between the parties with respect to the subject matter hereof."

Allen argued that fraudulent inducement invalidates the release provisions in the redemption agreement as "fraud vitiates whatever it touches," citing *Stonecipher v. Butts*, 591 S.W.2d 806, 809 (Tex. 1979). In rejecting that argument but holding that the release provisions in the redemption agreement were not sufficiently explicit to negate Allen's fraud in the inducement claims, the Court of Appeals wrote:

The threshold requirement for an effective disclaimer of reliance is that the contract language be "clear and unequivocal" in its expression of the parties' intent to disclaim reliance. [citations

omitted] In imposing this requirement, the Texas Supreme Court has balanced three competing concerns. First, a victim of fraud should not be able to surrender its fraud claims unintentionally. [citations omitted] Second, the law favors granting parties the freedom to contract knowing that courts will enforce their contracts' terms, as well as the ability to contractually resolve disputes between themselves fully and finally. [citations omitted] Third, a party should not be permitted to claim fraud when he represented in the parties' contract that he did not rely on a representation . . .

The Court then said that in view of these competing concerns, Texas allows a disclaimer of reliance to preclude a fraudulent inducement claim only if the parties' intent to release such claims "is clear and specific." Among the failings the Court found with the disclaimer language in the redemption agreement were: (i) it did not say none of the parties is relying upon any statement or any representation of any agent of the parties being released hereby; (ii) the broad language releasing "all claims, demands, rights, liabilities, and causes of action of any kind or nature" did not specifically release fraudulent inducement claims or disclaim reliance on Rees-Jones and Chief's representations (although it did release claims "of any kind or nature" (which necessarily includes fraudulent inducement), the elevated requirement of precise language requires more than a general catch-all--it must address fraud claims in clear and explicit language); (iii) the merger clause stated that the contract is the "final integration of the undertakings of the parties hereto and supersedes all prior agreements and undertakings," but did not include clear and unequivocal disclaimer of reliance on oral representations; (iv) the redemption agreement failed to state that the only representations that had been made were those set forth in the agreement; (v) it did not contain a broad disclaimer that no extra-contractual representations had been made and that no duty existed to make any disclosures; (vi) it did not provide that Allen had not relied on any representations or omissions by Chief; or (vii) it did not include a specific "no liability" clause stating that the party providing certain information will not be liable for any other person's use of the information.

The Court was careful to state it was not requiring that the words "disclaimer of reliance" must be stated in order for a disclaimer to preclude a fraudulent inducement claim or that each one of these issues must be addressed in every disclaimer. Rather, the Court stated that the redemption agreement lacked the following: "(1) an all-embracing disclaimer that Allen had not relied on any representations or omissions by Chief; (2) a specific 'no liability' clause stating that the party providing certain information will not be liable for any other person's use of the information; and (3) a specific waiver of any claim for fraudulent inducement based on misrepresentations or omissions."

Although the independent investigation clause stated that Allen "based his decision to sell" on (1) his own independent due diligence investigation, (2) his own expertise and judgment, and (3) the advice and counsel of his own advisors and consultants, the Court found that the statement of reliance on the identified factors did not clearly and unequivocally negate the possibility that Allen also relied on information he had obtained from Chief and Rees-Jones, and consistent with the terms of the redemption agreement, Allen could have relied on both. The Court found it incongruous to state that Allen could not rely on the information he was given, and noted the absence of the words "only," "exclusively," or "solely" are of critical importance in this case.

Rees-Jones and Devon argued that the redemption agreement contained language that released Allen's claims against them and that this language shows that the parties agreed broadly to disavow the factual theories he now asserts in his lawsuit. Although the redemption agreement released the parties from claims that arise from a determination that the redemption price did not reflect Chief's market value at closing, it did not negate Allen's claims that Rees-Jones made misrepresentations and omissions concerning Chief's future prospects. Further the release disclaimed any claim by Allen based on a change in value from the 2003 appraisal to the date of redemption only, but the language did not cover Allen's claims that Rees-Jones and Chief withheld information relating to Chief's future prospects and potential value.

The Court further wrote, citing *Forest Oil Corp. v. McAllen*, 268 S.W.3d 51 (Tex. 2008), that even a clear and unequivocal disclaimer of reliance may not bar a fraudulent inducement claim unless (1) the terms of the contract were negotiated or boilerplate; (2) the complaining party was represented by counsel; (3) the parties dealt with each other at arm's length; and (4) the parties were knowledgeable in business matters. The Court found for defendants on two of the factors (Allen as an oil and gas attorney could not complain that he was not represented by counsel and was not knowledgeable). The Court, however, found fact issues

Even in those cases where a Texas Court of Appeals upheld a plaintiffs' shareholder oppression claim, such as in *Davis v. Sheerin*,⁹⁴⁹ the defendant's behavior giving rise to the claim included allegations of breach of fiduciary duty. In *Davis*, the plaintiffs' argued that the Defendants receiving informal dividends to the exclusion of the plaintiff and the Defendants wasting corporate funds oppressed the plaintiffs as minority shareholders.⁹⁵⁰ This behavior violates the fiduciary duty of loyalty in Texas, which requires at a fundamental level both that directors not allow their personal interest to prevail over that of the corporation and that a director will not be permitted to derive a personal profit or advantage at the expense of the corporation.⁹⁵¹ As such, the *Davis* plaintiffs might have successfully brought a claim for breach of the fiduciary duty of loyalty, rather than for shareholder oppression.

Under Texas law, the corporation is generally the beneficiary of a successful fiduciary duty claim, and such a claim must be brought derivatively rather than directly.⁹⁵² However, under TBOC § 21.563, in a corporation with less than thirty-five shareholders, a shareholder may bring a direct fiduciary duty claim.⁹⁵³ In this case, an individual shareholder plaintiff may personally recover for the breach of fiduciary duty by a director.⁹⁵⁴ This allowance of a direct claim for breach of fiduciary duty challenges traditional notions of to whom fiduciary duties are owed.⁹⁵⁵ Similarly, those cases applying Texas law that allow a minority shareholder to prosecute a claim directly against a majority shareholder for "shareholder oppression" violate the traditional corporate governance notion that those in control of the corporation owe fiduciary duties to the corporation, not to individual shareholders.⁹⁵⁶

as to the other two factors (whether the contract was negotiated and whether the parties dealt with each other at arm's length) and declined to grant Defendant's motion for summary judgment. The Court declined to say whether all four tests must be satisfied for an otherwise clear and unequivocal disclaimer of reliance to be enforceable.

With respect to fiduciary duties, the Court held a formal fiduciary relationship is not created automatically between co-shareholders simply because the plaintiff is a minority shareholder in a closely-held corporation. The Court, however, held even if a formal fiduciary relationship did not ordinarily exist, "special facts" can create a fiduciary relationship and explained:

We conclude that there is a formal fiduciary duty when (1) the alleged-fiduciary has a legal right of control and exercises that control by virtue of his status as the majority owner and sole member-manager of a closely-held LLC and (2) either purchases a minority shareholder's interest or causes the LLC to do so through a redemption when the result of the redemption is an increased ownership interest for the majority owner and sole manager.

⁹⁴⁹ 754 S.W.2d 375, 377 (Tex. App.—Houston [1st Dist.] 1988, writ denied), overruled by *Ritchie v. Rupe*, 443 S.W.3d 856 (Tex. 2014).

⁹⁵⁰ *Id.* Similarly, the defendants' use of corporate funds for personal expenses without board of directors' approval in *Redmon v. Griffith* constitutes a violation of the duty of loyalty.

⁹⁵¹ *Supra* notes 277-287 and related text.

⁹⁵² *Gearhart Indus., Inc. v. Smith Int'l, Inc.*, 741 F.2d 707, 722 (5th Cir. 1984)

⁹⁵³ *See supra* note 510 and related text.

⁹⁵⁴ TBOC § 21.563(c)(1).

⁹⁵⁵ Charles Henry Still, *Shareholder Oppression Actions in Texas*, Texas Bar CLE (Oct. 13-14, 2011).

⁹⁵⁶ Charles Henry Still, *Shareholder Oppression Actions in Texas*, Texas Bar CLE (Oct. 13-14, 2011).

2.8.3. Delaware.

(a) Oppression Generally Not Separate Cause of Action in Delaware. Delaware law does not recognize shareholder oppression as a separate cause of action, although two Courts of Chancery have noted, in ruling on motions to dismiss, that shareholder oppression may, under certain circumstances, be a separate cause of action in Delaware.⁹⁵⁷

In *Riblet Products Corp. v. Nagy*,⁹⁵⁸ the Delaware Supreme Court declined to follow a Massachusetts Supreme Court holding that majority shareholders of a closely-held corporation breached their fiduciary duty to a minority shareholder when they terminated his employment and refused to reelect him as a salaried officer and director. *Nagy* held “that, although majority shareholders have fiduciary duties to minority shareholders *qua* shareholders, those duties are not implicated when the issue involves the rights of the minority shareholder *qua* employee under an employment contract.”⁹⁵⁹

In *Litle v. Waters*, the plaintiff’s complaint alleged that “the Director Defendants’ refusal to declare dividends so that Litle would suffer an oppressive tax burden constitute[d] a gross and oppressive abuse of discretion.”⁹⁶⁰ The Delaware Court of Chancery noted that the withholding of dividends was a “classic squeeze out situation,” but would only warrant court interference with the judgment of the Board of Directors on a theory of an oppressive or fraudulent abuse of discretion.⁹⁶¹ Because the Court of Chancery was not “aware of a Delaware case that has found oppressive behavior,” it chose to look to non-Delaware cases, particularly *Gimpel v. Bolstein*⁹⁶² from New York. While the Court of Chancery noted that “few, if any, cases have involved a set of facts egregious enough to meet the fraudulent, oppressive or gross abuse of discretion standard,” the plaintiff might be able to demonstrate at trial that the Director Defendants’

⁹⁵⁷ See *Gagliardi v. Trifoods Intl*, 683 A.2d 1049, 1051 (Del. Ch. 1996) (assuming that “for purposes of this motion, without deciding, that under some circumstances” Delaware fiduciary duty law recognizes a cause of action for oppression of minority shareholders); *Litle v. Waters*, C.A. No. 12155, 1992 WL 25758 (Del. Ch. Feb. 11, 1992) (“since I am not aware of a Delaware case that has found oppressive behavior, I look to decisions [of other states] that have found oppression for guidance”). In *Gagliardi* and *Litle*, both Courts of Chancery only analyzed the plaintiffs’ claims under shareholder oppression theories in order to rule on the pending motions to dismiss the claim, and recognized that Delaware case law does not provide a basis for a cause of action of minority shareholders. *Id.* Further the sections of the Courts of Chancery’s opinions addressing a cause of action for oppression of minority shareholders are unpublished opinions, indicating their lack of value for precedential purposes. As such, despite *Gagliardi* and *Litle*, Delaware law is clear in declining to adopt a cause of action for shareholder oppression.

⁹⁵⁸ *Riblet Products Corp. v. Nagy*, 683 A.2d 37, 37 (Del. 1996).

⁹⁵⁹ *Id.*

⁹⁶⁰ C.A. No. 12155, 1992 WL 25758, at *6 (Del. Ch. Feb. 11, 1992).

⁹⁶¹ *Id.*

⁹⁶² 477 N.Y.S.2d 1014, 1018 (1984). The *Gimpel* Court explored two different definitions for determining the existence of oppression: (i) a violation of the reasonable expectations of the minority and (ii) “burdensome, harsh and wrongful conduct; a lack of probity and fair dealing in the affairs of a company to the prejudice of some of its members; or a visible departure from the standards of fair dealing, and a violation of fair play on which every shareholder who entrusts his money to a company is entitled to rely.” *Id.* at 1018. The Delaware Court of Chancery applied both of these standards in *Litle*. 1992 WL 25758, at *8.

behavior was oppressive.⁹⁶³ Thus, the Court of Chancery denied the Director Defendants' motion to dismiss the shareholder oppression claim in the case.⁹⁶⁴

In *Garza v. TV Answer, Inc.*,⁹⁶⁵ the Chancery Court did not read *Little* as establishing an independent cause of action for oppressive abuse of discretion distinct from a cause of action based on a breach of fiduciary duty and said that *Little* simply held that the business judgment rule does not protect director actions if such actions constitute a gross or fraudulent abuse of discretion. The Chancery Court held that Garza could only recover for the various allegedly wrongful actions of the defendant directors if he could prove that the directors' actions were motivated by a wrongful purpose such that the business judgment rule was no longer applicable.

In *Gagliardi v. Trifoods Int'l*, the plaintiff attempted to bring a shareholder oppression claim against his former employer, a Delaware corporation, by asserting "a mélange of allegations that do not fit easily together either factually or conceptually."⁹⁶⁶ Specifically, the plaintiff in *Gagliardi* alleged that other shareholders:

1. failed and refused to furnish shareholder information as requested;
2. failed and refused to keep Gagliardi informed as requested, even though he had invented all the products which TriFoods was selling;
3. failed to enter into arrangements with Gagliardi;
4. repeatedly diluted Gagliardi's share interest in TriFoods;
5. frustrated Gagliardi's attempts to sell his stock;
6. repeatedly threatened litigation against Gagliardi if he did not remain inactive and silent.

[] The foregoing 'were committed for the sole or primary purpose of entrenching Hart and Adams in office'⁹⁶⁷

Rejecting the plaintiff's "mélange" of theories, the Delaware Court of Chancery held:

[A]ccepting the allegations of Count III as true, with one exception, neither individually nor collectively do they make out a violation of a legal or equitable duty. The board has no duty in law or in equity to furnish shareholder information as requested; Section 220 of the Delaware corporation law describes the statutory obligations and it provides a remedy for its violation. The board has no legal or other duty 'to enter into arrangements with Gagliardi'; nor does the board have any obligation not to enter into or authorize transactions that will have an effect of

⁹⁶³ 1992 WL 25758, at *9.

⁹⁶⁴ *Id.*

⁹⁶⁵ No. 12784, 1993 WL 77186, at *1 (Del. Ch. Mar. 11, 1993).

⁹⁶⁶ *Gagliardi v. Trifoods Intl*, 683 A.2d 1049, 1051 (Del. Ch. 1996).

⁹⁶⁷ *Id.*

diluting his proportionate shareholding; nor does it have a duty not to threaten him with litigation so long as it acts in furtherance of its good faith view of the corporate interest. One cannot convert a series of permissible acts into a cause of action by the single expedient of alleging that they were done for the purpose of entrenching defendants.⁹⁶⁸

(b) Relationship to Fiduciary Duties. While Delaware courts have generally not recognized a shareholder oppression cause of action, they have turned to fiduciary duties—specifically the fiduciary duty of loyalty—as a source of relief for plaintiffs.⁹⁶⁹ Delaware recognizes that a controlling shareholder⁹⁷⁰ (or a control group)⁹⁷¹ can “exert its will over the enterprise in the manner of the board itself” and therefore can abuse its position to benefit itself to the detriment of minority shareholders.⁹⁷² A controlling shareholder, however, may act in its own self-interest without regard to any detriment to the minority shareholder provided that such an action is undertaken in good faith.⁹⁷³

In *Blaustein v. Lord Baltimore Capital Corp.*,⁹⁷⁴ the Delaware Supreme Court held that a minority stockholder in a closely held corporation does not have a right to a non-conflicted Board decision on whether to repurchase her shares under either common law fiduciary duty principles or under the implied covenant of good faith and fair dealing. This dispute arose from a stockholder’s unsuccessful attempts to sell her stock in a closely held Delaware corporation for a price better than a 52% discount from the net asset value of her shares offered by the Board. Plaintiff unsuccessfully tried to negotiate, and made several proposals for a buyout at a less severe discount. Plaintiff alleged that the Board acted out of self-interest when it refused to negotiate a repurchase of her shares at anything less than a 52% discount, and that these allegations of self-interest were sufficient to trigger entire fairness review because Blaustein had a “right to a non-conflicted corporate decision” on whether her shares should be repurchased and at what price. Blaustein relied on both common law fiduciary duty principles and the shareholders’ agreement in support of her claim. The Supreme Court, in rejecting plaintiff’s claims, wrote:

Under common law, the directors of a closely held corporation have no general fiduciary duty to repurchase the stock of a minority stockholder. An investor must rely on contractual protections if liquidity is a matter of concern. Blaustein has no inherent right to sell her stock to the company at “full value,” or

⁹⁶⁸ *Id.* (emphasis added). The *Gagliardi* Court allowed the plaintiff to amend his allegation that the defendants intentionally frustrated his attempt to sell his stock.

⁹⁶⁹ *Infra* notes 975-979 and related text.

⁹⁷⁰ *Gentile v. Rossette*, 906 A.2d 91, 100 (Del. 2006); Stephen A. Radin, *THE BUSINESS JUDGMENT RULE, C. The Controlling Shareholder’s Duty of Loyalty* (Aug. 2009). *See supra* note 499 and related text.

⁹⁷¹ *Dubroff v. Wren Holdings, LLC*, C.A. No. 3940-VCN, 2011 Del. Ch. LEXIS 164, at *24 (Del. Ch. Oct. 28, 2011). *See supra* notes 404-411 and related text.

⁹⁷² *Abraham v. Emerson Radio Corp.*, 901 A.2d 751, 752 (Del. Ch. 2006).

⁹⁷³ *In re CompuCom Sys., Inc. Shareholders Litigation*, No. 499-N, 2005 WL 2481325, at *1 (Del. Ch. Sept. 29, 2005).

⁹⁷⁴ C.A. No. 272, 2013, 2014 Del. LEXIS 30 (Del. Jan. 21, 2014).

any other price. It follows that she has no right to insist on the formation of an independent board committee to negotiate with her.

The Shareholders' Agreement provides the only protection available to Blaustein. But the relevant provision, Paragraph 7(d), gives the stockholder and the company discretion as to whether to engage in a transaction, and as to the price. It does not impose any affirmative duty on either party to consider or negotiate any repurchase proposal. * * *

The implied covenant of good faith and fair dealing cannot be employed to impose new contract terms that could have been bargained for but were not. Rather, the implied covenant is used in limited circumstances to include "what the parties would have agreed to themselves had they considered the issue in their original bargaining positions at the time of contracting." Here, the parties did consider whether, and on what terms, minority stockholders would be able to have their stock repurchased. Paragraph 7(d) does not contain any promise of a "full value" price or independent negotiators. Because the implied covenant does not give parties the right to renegotiate their contracts, the trial court correctly denied Blaustein's proposed new claim.

In *In re Siliconix Inc. Shareholders Litigation*, a Delaware Court of Chancery analyzed minority shareholders' claim that majority shareholders violated their duty of loyalty in crafting the "oppressive" structure of a proposed tender offer.⁹⁷⁵ Vice Chancellor Noble first noted that as a general principle, a controlling shareholder extending an offer for minority-held shares in the controlled corporation is under no obligation, absent evidence that material information about the offer has been withheld or misrepresented or that the offer is coercive in some significant way, to offer any particular price for the minority-held stock.⁹⁷⁶ Instead, as long as the tender offer is pursued properly, the free choice of the minority shareholders to reject the tender offer provides sufficient protection.⁹⁷⁷ The plaintiffs alleged that the Siliconix Board breached its duty of loyalty as a result of the interested status of at least a substantial majority of the Board.⁹⁷⁸ The Chancery Court proceeded to analyze the majority shareholders' self-dealing behavior under a duty of loyalty analysis, instead of entertaining a cause of action for shareholder oppression based on the structure of the transaction.⁹⁷⁹

Similarly, in *Harbor Finance Partners v. Huizenga*, a Court of Chancery addressed a shareholder plaintiff's contention that an acquisition was a self-interested transaction effected for the benefit of directors who owned a substantial block of shares and that the terms of the transaction were unfair to shareholders, and as a result, constituted a violation of the duty of loyalty.⁹⁸⁰ Vice Chancellor Strine held that the shareholder oppression claim was not necessary to protect minority stockholders from controlling stockholders; instead, looking to the Board's

⁹⁷⁵ *In re Siliconix Inc. Shareholders Litig.*, C.A. No. 18700, 2001 WL 716787, at *1 (Del. Ch. June 19, 2001).

⁹⁷⁶ *Id.*

⁹⁷⁷ *Id.*

⁹⁷⁸ *Id.*

⁹⁷⁹ *Id.*

⁹⁸⁰ 751 A.2d 879, 892 (Del. Ch. 1999).

fiduciary duties offered enough protection.⁹⁸¹ As the Court of Chancery did in *Siliconix*, the *Harbor Finance* court analyzed the majority shareholders' self-dealing behavior under a duty of loyalty analysis.

These cases are not alone, as Delaware courts have frequently shown that cases wherein oppressive conduct is alleged are properly analyzed as fiduciary duty cases.⁹⁸²

2.9. Other Corporate Governance Considerations.

2.9.1. Change in Control Provisions in Loan Documents. Lenders are frequently concerned about the effect of a change in control of a company on the company's ability to pay its debts. As a result it is common for loan agreements, debt indentures and similar documents to contain provisions to the effect that a change in control of the company gives the lender a right to accelerate the maturity of the debt. Because they can make it more difficult and expensive for a third party to take over the company and hence may tend to protect positions of incumbent management, they can be subject to judicial scrutiny.

A change in control provision in a bond indenture of Amylin Pharmaceuticals, Inc. was scrutinized in *San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals, Inc.*⁹⁸³ Amylin's indenture provided holders of publicly traded convertible notes the right to demand redemption at face value upon the occurrence of certain events, including a "fundamental change," which was defined in part to have occurred if at any time the "continuing directors" do not constitute a majority of the Board. The indenture defined "continuing directors" in part as "any new directors whose election to the Board of Directors or whose nomination for election by the stockholders of the company was *approved* by at least a majority of the directors then still in office" (emphasis added).

Litigation ensued after two insurgent stockholders each nominated separate five-person slates for election to Amylin's twelve-member Board. Election of seven of the insurgent nominees without the "approval" of the incumbent Board, which had nominated its own slate, would have constituted a "fundamental change" under the continuing directors provision, triggering the noteholders' put rights at a time when the notes were trading at a deep discount.

Another Amylin stockholder brought a putative class action suit alleging that the Amylin Board (i) breached its fiduciary duties of care and loyalty in approving the indenture; (ii) breached its fiduciary duties of care and loyalty in failing to approve the dissident nominees and thereby avoiding triggering the change-in-control provision; and (iii) breached various disclosure obligations. The plaintiff also sought a declaration that the continuing directors

⁹⁸¹ *Id.* at 899.

⁹⁸² See, e.g., *Superior Vision Services v. Reliastar Life Ins. Co.*, C.A. No. 1668-N, 2006 WL 2521426, at *1 (Del. Ch. Aug. 25, 2006) (analyzing plaintiff's allegations that a controlling shareholder is unfairly interfering with payment of dividends as breach of fiduciary duty); *Orloff v. Shulman*, No. 852-N, 2005 WL 3272355, at *1 (Del. Ch. Nov. 23, 2005) (addressing plaintiffs' claim that the defendants violated their fiduciary duties by mismanaging the corporation to the financial detriment of plaintiffs); *In re Digex, Inc. Shareholders Litigation*, 789 A.2d 1176, 1192 (Del. Ch. 2000) (noting that statutorily conferred power must be exercised within the constraints of the duty of loyalty).

⁹⁸³ 938 A.2d 304, 306 (Del. Ch. 2009).

provision was unenforceable, as well as a mandatory injunction requiring the Amylin Board to approve the insurgent nominees.

Prior to trial, the parties reached a partial settlement pursuant to which the plaintiff dropped its loyalty and disclosure claims and agreed not to seek monetary damages from the Amylin directors. In exchange, the Amylin Board publicly stated that it would “approve” the dissident stockholder nominees for purposes of the continuing directors provision, contingent upon its receipt of a final adjudication that it possessed the contractual right to “approve” the nominees, but simultaneously recommend and endorse its own slate. As a result, the trial focused on whether the Board had the power and the right to approve the dissident stockholder nominees and whether the Board had breached its duty of care in approving the Indenture.

The Court determined that the Amylin Board had the authority under the indenture to approve the stockholder-nominated slate and still recommend and endorse its own slate, the Court turned to whether Amylin’s Board properly exercised its right to do so in this case. The Court noted that the Board’s action would be consistent with the implied duty of good faith and fair dealing, which inheres in all contracts, including the indenture, so long as the “board determines in good faith that the election of one or more of the nominees would not be materially adverse to the interests of the corporation or its stockholders.” The Court ultimately declined for procedural reasons to determine whether, in exercising its authority, Amylin’s Board had complied with the implied duty of good faith and fair dealing for procedural reasons and rejected plaintiff’s claim that in approving the indenture, Amylin’s directors violated their duty of care because the Board had not expressly known during its approval process that the indenture contained a continuing directors provision. Although it rejected the due care claim because the Board had “retained highly-qualified counsel, ... sought advice from Amylin’s management and investment bankers,” and “asked its counsel if there was anything ‘unusual or not customary’” before approving the indenture, the Court cautioned:

Outside counsel advising a board in such circumstances should be especially mindful of the board’s continuing duties to the stockholders to protect their interests. Specifically, terms which may affect the stockholders’ range of discretion in exercising the franchise should, even if considered customary, be highlighted to the board. In this way, the board will be able to exercise its fully informed business judgment.

The plaintiff’s attorneys were awarded fees and expenses of \$2.9 million for their role in disabling the “continuing director” provisions in the indenture that allegedly hindered shareholder voting for directors.⁹⁸⁴

Amylin was followed in *Kallick v. SandRidge Energy, Inc.*,⁹⁸⁵ in which the Court enjoined the Board of a borrower from soliciting consent revocations in connection with a proxy contest launched by a stockholder to install its own directors on the borrower’s Board, until the borrower’s incumbent Board approved the proposed directors in order not to trigger a change of

⁹⁸⁴ *San Antonio Fire & Police Pension Fund v. Bradbury*, C.A. No. 4446-VCN, 2010 Del. Ch. LEXIS 218, at *2 (Del. Ch. Oct. 28, 2010).

⁹⁸⁵ C.A. No. 8182-CS, 2013 WL 868942 (Del. Ch. Mar. 8, 2013).

control provision in the borrower's credit agreement. While relying on *Amylin* and affirming that the Board has a fiduciary duty to approve the directors nominated by a dissident stockholder, the Court also held that unless a Board can identify a specific and substantial risk that the proposed directors pose to the corporation or its creditors it "should approve the rival slate and allow the stockholders to choose the corporation's directors without fear of adverse financial consequences."

A credit agreement containing change-of-control provisions (agreed to against the backdrop of a threatened proxy contest and ongoing stockholder pressure) was successfully challenged in *Pontiac Gen. Employees Ret. Sys. v. Ballantine*.⁹⁸⁶ In 2010, Healthways, Inc. entered into an agreement with a poison put provision triggered by a change of control of the Board (commonly known as a "proxy put") which allowed the lenders to accelerate repayment of the debt if, during a period of 24 consecutive months, a majority of the members of the Board who were directors at the beginning of that period are no longer directors at the end of that period (other than if the new directors were approved by the directors who are stepping down).

Healthways subsequently became the target of a possible proxy contest, resulting in the declassification of the Board. Eight days after the stockholder vote, the Board entered into a new amended and restated credit agreement containing a "dead hand" proxy put, in which the election of a majority of new directors within the 24-month period would trigger the provision even if the resigning directors were to approve the appointment of the new directors.

Litigation ensued in which a stockholder sought a declaratory judgment that the proxy put is unenforceable, claiming that the directors breached their fiduciary duty to the stockholders of Healthways by agreeing to the proxy put under the circumstances in which they did and that SunTrust aided and abetted that breach by agreeing to the proxy put. In their motion to dismiss the claims, the defendant directors argued that the case was not ripe, because the proxy put will not come into play unless and until there is another contested election for the Board, and that even were there to be more turnover on the Board, the banks might still decide to waive the put.

The defendant SunTrust, as agent for the banks, also argued that the element of knowing participation in a breach, which is required to make a claim for aiding and abetting, was missing. SunTrust emphasized that it had negotiated with Healthways at arm's length and had simply been trying to negotiate the best possible deal for itself, without attempting to induce a breach of fiduciary duty. SunTrust argued that the proxy put has a valid business purpose of allowing the lender to reassess the situation and regain comfort after the borrower has gone through significant change. SunTrust also emphasized that proxy puts are "market" and that a decision to invalidate them would have an effect reaching far beyond the particular credit agreement at issue.

In rejecting the directors' argument that the plaintiff's claim is not ripe for judicial determination, the Vice Chancellor explained that the problem with the proxy put is its deterrent effect and that the court does not need to wait until a proxy contest for the issue to become ripe. In rejecting SunTrust's motion to dismiss the claim of aiding and abetting, the court acknowledged that negotiating at arm's length usually does negate a claim of aiding and

⁹⁸⁶ C.A. No. 9789-VCL, 2014 WL 6388645 (Del. Ch. Oct. 14, 2014) (TRANSCRIPT)).

abetting, but said this only means that a party can negotiate for the best economic terms it can get. A party cannot, however, propose, insist on and incorporate terms that take advantage of a conflict of interest that its fiduciary counterpart faces. The lender cannot ask for a term that puts the Board of the borrower at odds with its stockholders, which is the effect of a proxy put because it incentivizes the directors to accept that provision for the sake of entrenching themselves. When a lender knowingly negotiates for such a term, it knowingly participates in the breach, even though it may be “market” for lenders to insist on such change in control provisions.

2.9.2. Business Combination Statutes. Both Delaware and Texas provide protections to shareholders of public companies against interested shareholder transactions that occur after a shareholder has acquired a 15% to 20% ownership interest. The Delaware limitations are found in § 203 of the DGCL and the Texas limitations are found in Chapter 21, Subchapter M of the TBOC.

(a) DGCL § 203. DGCL § 203 imposes restrictions on transactions between public corporations and certain stockholders defined as “*interested stockholders*” unless specific conditions have been met. In general, § 203 provides that a publicly held Delaware corporation may not engage in a business combination with any interested stockholder for a period of three years following the date the stockholder first became an interested stockholder unless (i) prior to that date the board of directors of the corporation approved the business combination or the transaction that resulted in the stockholder becoming an interested stockholder, (ii) the interested stockholder became an interested stockholder as a result of acquiring at least 85% of the voting stock of the corporation, excluding shares held by directors and officers and employee benefit plans in which participants do not have the right to determine confidentially whether their shares will be tendered in a tender or exchange offer, or (iii) the transaction is approved by the board of directors and by the affirmative vote of at least two-thirds of the outstanding shares excluding the shares held by the interested stockholder. In the context of a corporation with more than one class of voting stock where one class has more votes per share than another class, “85% of the voting stock” refers to the percentage of the votes of such voting stock and not to the percentage of the number of shares.⁹⁸⁷

An interested stockholder is generally defined under DGCL § 203(c)(5) as any person that directly or indirectly owns or controls or has beneficial ownership or control of at least 15% of the outstanding shares of the corporation.⁹⁸⁸ A business combination is defined under DGCL

⁹⁸⁷ See DGCL § 203(c)(8).

⁹⁸⁸ DGCL § 203(c)(9) defines “owner” broadly as follows:

(9) “Owner,” including the terms “own” and “owned,” when used with respect to any stock, means a person that individually or with or through any of its affiliates or associates:

(i) Beneficially owns such stock, directly or indirectly; or

(ii) Has (A) the right to acquire such stock (whether such right is exercisable immediately or only after the passage of time) pursuant to any agreement, arrangement or understanding, or upon the exercise of conversion rights, exchange rights, warrants or options, or otherwise; provided, however, that a person shall not be deemed the owner of stock tendered pursuant to a tender or exchange offer made by such person or any of such person’s affiliates or associates until such tendered stock is accepted for purchase or exchange; or (B) the right to vote such stock pursuant to any agreement, arrangement or understanding; provided, however, that a person shall not be deemed the owner of any stock because of such person’s right to vote

§ 203(c)(3) to include (i) mergers, (ii) consolidations, (iii) direct or indirect sales, leases, exchanges, mortgages, transfers and other dispositions of assets to the interested stockholder having an aggregate market value greater than 10% of the total aggregate market value of the assets of the corporation, (iv) various issuances of stock and securities to the interested stockholder that are not issued to other stockholders on a similar basis and (v) various other transactions in which the interested stockholder receives a benefit, directly or indirectly, from the corporation that is not proportionally received by other stockholders.

The provisions of DGCL § 203 apply only to public corporations (i.e., corporations the stock of which is listed on a national securities exchange, authorized for quotation on interdealer quotation system of a registered national securities association or held of record by more than 2,000 stockholders).⁹⁸⁹ The provisions of DGCL § 203 also will not apply to certain stockholders who held their shares prior to the adoption of DGCL § 203. In addition, DGCL § 203 will not apply if the certificate of incorporation of the corporation or the bylaws approved by stockholders provides that the statute will not apply; provided that if the corporation is subject to DGCL § 203 at the time of adoption of an amendment eliminating the application of DGCL § 203, the amendment will not become effective for 12 months after adoption and the section will continue to apply to any person who was an interested stockholder prior to the adoption of the amendment.⁹⁹⁰

A vote to so waive the protection of DGCL § 203 is sometimes referred to as a “§ 203 waiver” and requires that the directors act consistently with their fiduciary duties of care and loyalty.⁹⁹¹ Significantly, in transactions involving a controlling stockholder, the board’s decision to grant a DGCL § 203 waiver to a buyer may present conflict issues for a board dominated by representatives of the controlling stockholders.⁹⁹²

(b) TBOC. TBOC Chapter 21, Subchapter M deals with business combinations involving public companies and related party transactions where there is a change of control after which there are minority shareholders by imposing a special voting requirement for business combinations and other transactions involving a new controlling shareholder.⁹⁹³ These anti-

such stock if the agreement, arrangement or understanding to vote such stock arises solely from a revocable proxy or consent given in response to a proxy or consent solicitation made to 10 or more persons; or

(iii) Has any agreement, arrangement or understanding for the purpose of acquiring, holding, voting (except voting pursuant to a revocable proxy or consent as described in item (B) of subparagraph (ii) of this paragraph), or disposing of such stock with any other person that beneficially owns, or whose affiliates or associates beneficially own, directly or indirectly, such stock.

⁹⁸⁹ DGCL § 203(b).

⁹⁹⁰ *Id.*

⁹⁹¹ *See In re Digex, Inc. S’holders Litig.*, 789 A.2d 1176, 1179 (Del. Ch. 2000).

⁹⁹² *Id.*

⁹⁹³ TBOC §§ 21.601-21.610. State corporation statutes intended to restrain some of the abuses associated with hostile takeovers were validated by the United States Supreme Court in *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69 (1987). *See Amanda Acquisition Corp. v. Universal Foods Corp.*, 877 F.2d 496, 505-09 (7th Cir. 1989), *cert. denied*, 493 U.S. 955 (1989) (upholding Wisconsin’s 3-year moratorium statute); Byron F. Egan & Bradley L. Whitlock, *State Shareholder Protection Statutes*, Address at the University of Texas 11th Annual Conference on Securities Regulation and Business Law Problems (Mar. 10, 1989).

takeover provisions (i) apply only to an “issuing public corporation”⁹⁹⁴ and (ii) prohibit a “business combination”⁹⁹⁵ (which includes a merger, share exchange, sale of assets, reclassification, conversion or other transaction between the issuing public corporation and any “affiliated shareholder”⁹⁹⁶) for three years after the affiliated shareholder became such unless (iii) the “business combination” is approved by the holders of not less than two-thirds of the voting shares not beneficially owned by the affiliated shareholder at a meeting of shareholders held not less than six months after the affiliated shareholder became such or, prior to the affiliated shareholder becoming such, the Board approved either the business combination or the affiliated shareholder’s acquisition of the shares that made him an affiliated shareholder.⁹⁹⁷ The TBOC also confirms that a director, in discharging his duties, may consider the long-term, as well as the short-term, interests of the corporation and its shareholders.⁹⁹⁸ The TBOC does not contain the Delaware 85% unaffiliated share tender offer exception, which was considered by the drafters to be a major loophole in the Delaware statute, and attempts to clarify various uncertainties and ambiguities contained in the Delaware statute.

2.9.3. Liability for Unlawful Distributions. Both Texas and Delaware impose personal liability on directors who authorize the payment of distributions to shareholders (including share purchases) in violation of the statutory requirements.⁹⁹⁹

Under Delaware law, liability for an unlawful distribution extends for a period of six years to all directors other than those who expressly dissent, with the standard of liability being negligence.¹⁰⁰⁰ DGCL § 172, however, provides that a director will be fully protected in relying in good faith on the records of the corporation and such other information, opinions, reports, and statements presented to the corporation by the corporation’s officers, employees and other persons. This applies to matters that the director reasonably believes are within that person’s professional or expert competence and have been selected with reasonable care as to the various components of surplus and other funds from which distributions may be paid or made.¹⁰⁰¹ Directors are also entitled to receive contribution from other directors who may be liable for the distribution and are subrogated to the corporation against shareholders who received the distribution with knowledge that the distribution was unlawful.¹⁰⁰² Under the Texas Corporate

⁹⁹⁴ “Issuing public corporation” is defined as a Texas corporation that has 100 or more shareholders of record, has a class of voting shares registered under the Securities Exchange Act of 1934, or has a class of voting shares qualified for trading on a national market system. TBCA arts. 13.02(A)(6), 13.03; TBOC §§ 21.601(1), 21.606. These TBCA and TBOC provisions do not apply to corporations that are organized under the laws of another state, but that have a substantial nexus to Texas, because such a “foreign application” provision might jeopardize the constitutionality thereof. *See, e.g., Tyson Foods, Inc. v. McReynolds*, 700 F. Supp. 906, 910-14 (M.D. Tenn. 1988); *TLX Acquisition Corp. v. Telex Corp.*, 679 F. Supp. 1022, 1029-30 (W.D. Okla. 1987).

⁹⁹⁵ TBOC § 21.604.

⁹⁹⁶ “Affiliated shareholder” is defined as a shareholder beneficially owning 20% or more of the corporation’s voting shares and certain of its related persons. TBOC § 21.602.

⁹⁹⁷ TBOC § 21.606.

⁹⁹⁸ TBOC § 21.401(b).

⁹⁹⁹ TBOC § 21.316; TBCA art. 2.41(A)(1); DGCL § 174(a).

¹⁰⁰⁰ DGCL § 174.

¹⁰⁰¹ DGCL § 172.

¹⁰⁰² DGCL § 174(b), (c).

Statutes, liability for an unlawful distribution extends for two years instead of six years and applies to all directors who voted for or assented to the distribution (assent being presumed if a director is present and does not dissent).¹⁰⁰³ A director will not be liable for an unlawful distribution if at any time after the distribution, it would have been lawful.¹⁰⁰⁴ A similar provision does not exist in Delaware. A director will also not be liable under the Texas Corporate Statutes for an unlawful distribution if the director:

- (i) relied in good faith and with ordinary care on information relating to the calculation of surplus available for the distribution under the Texas Corporate Statutes;
- (ii) relied in good faith and with ordinary care on financial and other information prepared by officers or employees of the corporation, a committee of the board of directors of which he is not a member or legal counsel, investment bankers, accountants and other persons as to matters the director reasonably believes are within that person's professional or expert competence;
- (iii) in good faith and with ordinary care, considered the assets of the corporation to have a value equal to at least their book value; or
- (iv) when considering whether liabilities have been adequately provided for, relied in good faith and with ordinary care upon financial statements of, or other information concerning, any other person that is contractually obligated to pay, satisfy, or discharge those liabilities.¹⁰⁰⁵

As in Delaware, a director held liable for an unlawful distribution under the Texas Corporate Statutes will be entitled to contribution from the other directors who may be similarly liable. The director can also receive contribution from shareholders who received and accepted the distribution knowing it was not permitted in proportion to the amounts received by them.¹⁰⁰⁶ The Texas Corporate Statutes also expressly provide that the liability of a director for an unlawful distribution provided for under the Texas Corporate Statutes¹⁰⁰⁷ is the only liability of the director for the distribution to the corporation or its creditors, thereby negating any other theory of liability of the director for the distribution such as a separate fiduciary duty to creditors or a tortious violation of the Uniform Fraudulent Transfer Act.¹⁰⁰⁸ No similar provision is found in the DGCL.

2.9.4. Reliance on Reports and Opinions. Both Texas and Delaware provide that a director in the discharge of his duties and powers may rely on information, opinions and reports prepared by officers and employees of the corporation and on other persons as to matters that the director

¹⁰⁰³ TBOC §§ 21.316, 21.317; TBCA art. 2.41(A).

¹⁰⁰⁴ TBOC § 21.316(b); TBCA art. 2.41(A).

¹⁰⁰⁵ TBOC § 21.316; TBCA arts. 2.41(C), 2.41(D).

¹⁰⁰⁶ TBOC § 21.318(a); TBCA arts. 2.41(E), 2.41(F).

¹⁰⁰⁷ TBOC § 21.316; TBCA art. 2.41.

¹⁰⁰⁸ *See* TBOC § 21.316(d); TBCA art. 2.41(G).

reasonably believes are within that person’s professional or expert competence.¹⁰⁰⁹ In Delaware, this reliance must be made in good faith and the selection of outside advisors must have been made with reasonable care.¹⁰¹⁰ In Texas, reliance must be made both in good faith and with ordinary care.¹⁰¹¹

2.9.5. Inspection of Records by Directors. Both Texas and Delaware have codified the common law right of directors to examine the books and records of a corporation for a purpose reasonably related to the director’s service as a director.¹⁰¹² The right to receive information in furtherance of a director’s performance of his duties does not permit him to use the information to advance his personal interests.¹⁰¹³

2.9.6. Inspection of Records by Shareholders.

Texas. Under TBOC § 21.218,¹⁰¹⁴ a shareholder of a Texas corporation has the right to examine the books and records of the corporation at any reasonable time upon written notice stating a proper purpose if he (i) has been a shareholder for six month or (ii) holds at least 5% of its outstanding shares.¹⁰¹⁵ A shareholder’s right to inspect corporate books in Texas exists so that the shareholder may “ascertain whether the affairs of the corporation are properly conducted and that he may vote intelligently on questions of corporate policy and management.”¹⁰¹⁶

¹⁰⁰⁹ See TBOC §§ 21.316(c), 3.102; TBCA art. 2.41(D); DGCL § 141(e).

¹⁰¹⁰ DGCL § 141(e); see also *Brehm v. Eisner*, 746 A.2d 244, 248 (Del. 2000).

¹⁰¹¹ TBOC § 21.316(c)(1); TBCA art. 2.41(D).

¹⁰¹² TBOC § 3.152; TBCA art. 2.44(B); DGCL § 220(d).

¹⁰¹³ *Holdgreiwe v. Nostalgia Network, Inc.*, C.A. No. 12914, 1993 WL 144604, at *1 (Del. Ch. April 29, 1993); *Brophy v. Cities Service Co.*, 70 A.2d 5, *7 (Del. Ch. 1949); see also *Shocking Technologies, Inc. v. Michael*, C.A. No. 7164-VCN, 2012 Del. Ch. LEXIS 224, at *2 (Del. Ch. Oct. 1, 2012), *supra* note 376; *Kahn v. Kolberg Kravis Roberts & Co., L.P.*, 23 A.3d 831, 838 (Del. 2011) (“[A] fiduciary cannot use confidential corporate information for his own benefit. As the court recognized in *Brophy*, it is inequitable to permit the fiduciary to profit from using confidential corporate information. Even if the corporation did not suffer actual harm, equity requires disgorgement of that profit.”). See *supra* note 321.

¹⁰¹⁴ TBOC § 21.218 provides as follows:

Sec. 21.218. EXAMINATION OF RECORDS. (a) In this section, a holder of a beneficial interest in a voting trust entered into under Section 6.251 is a holder of the shares represented by the beneficial interest.

(b) Subject to the governing documents and on written demand stating a proper purpose, a holder of shares of a corporation for at least six months immediately preceding the holder's demand, or a holder of at least five percent of all of the outstanding shares of a corporation, is entitled to examine and copy, at a reasonable time, the corporation's relevant books, records of account, minutes, and share transfer records. The examination may be conducted in person or through an agent, accountant, or attorney.

(c) This section does not impair the power of a court, on the presentation of proof of proper purpose by a beneficial or record holder of shares, to compel the production for examination by the holder of the books and records of accounts, minutes, and share transfer records of a corporation, regardless of the period during which the holder was a beneficial holder or record holder and regardless of the number of shares held by the person.

¹⁰¹⁵ See *Burton v. Cravey*, 759 S.W.2d 160, 162 (Tex. App.—Houston [1st Dist.] 1988, no writ, disapproved on other grounds, *Huie v. DeShazo*, 922 S.W.2d 920 (Texas 1996).

¹⁰¹⁶ *Johnson Ranch Royalty Co. v. Hickey*, 31 S.W.2d 150, 153 (Tex. App.—Amarillo 1930, writ ref'd).

A shareholder's substantive rights to inspect corporate documents and the procedures for demanding an inspection of books and records are independent from the discovery rules in litigation.¹⁰¹⁷ In *Burton v. Cravey*,¹⁰¹⁸ the Court held that objections under the rules of discovery do not apply to a request for inspection of books and records, even those requests that are "overly broad, unduly burdensome, and requires the production of irrelevant information." Further, restrictions and procedural requirements on a shareholder's right of inspection do not apply to a shareholder's discovery requests in ongoing litigation. A shareholder who is also in litigation with the corporation has the ability to use either a books and records request under TBOC § 22.218 or discovery in the litigation.¹⁰¹⁹

Delaware. DGCL § 220 provides that a stockholder has a right to inspect a corporation's books and records for a proper purpose related to his interest as a stockholder.¹⁰²⁰ The most

¹⁰¹⁷ *San Antonio Models, Inc. v. Peebles*, 686 S.W.2d 666, 670 (Tex. App.—San Antonio 1985, no writ)

¹⁰¹⁸ *Burton*, 759 S.W.2d at 162.

¹⁰¹⁹ *San Antonio Models, Inc.*, 686 S.W.2d at 670.

¹⁰²⁰ DGCL §§ 220(b) and (c) provide:

(b) Any stockholder, in person or by attorney or other agent, shall, upon written demand under oath stating the purpose thereof, have the right during the usual hours for business to inspect for any proper purpose, and to make copies and extracts from:

(1) The corporation's stock ledger, a list of its stockholders, and its other books and records; and

(2) A subsidiary's books and records, to the extent that:

a. The corporation has actual possession and control of such records of such subsidiary; or

b. The corporation could obtain such records through the exercise of control over such subsidiary, provided that as of the date of the making of the demand:

1. The stockholder inspection of such books and records of the subsidiary would not constitute a breach of an agreement between the corporation or the subsidiary and a person or persons not affiliated with the corporation; and

2. The subsidiary would not have the right under the law applicable to it to deny the corporation access to such books and records upon demand by the corporation.

In every instance where the stockholder is other than a record holder of stock in a stock corporation, or a member of a nonstock corporation, the demand under oath shall state the person's status as a stockholder, be accompanied by documentary evidence of beneficial ownership of the stock, and state that such documentary evidence is a true and correct copy of what it purports to be. A proper purpose shall mean a purpose reasonably related to such person's interest as a stockholder. In every instance where an attorney or other agent shall be the person who seeks the right to inspection, the demand under oath shall be accompanied by a power of attorney or such other writing which authorizes the attorney or other agent to so act on behalf of the stockholder. The demand under oath shall be directed to the corporation at its registered office in this State or at its principal place of business.

(c) If the corporation, or an officer or agent thereof, refuses to permit an inspection sought by a stockholder or attorney or other agent acting for the stockholder pursuant to subsection (b) of this section or does not reply to the demand within 5 business days after the demand has been made, the stockholder may apply to the Court of Chancery for an order to compel such inspection. The Court of Chancery is hereby vested with exclusive jurisdiction to determine whether or not the person seeking inspection is entitled to the inspection sought. The Court may summarily order the corporation to permit the stockholder to inspect the corporation's stock ledger, an existing list of stockholders, and its other books and records, and to make

important factor in the request for inspection of books and records is the stated “proper purpose.” Proper purpose under DGCL § 220 means “a purpose reasonably related to such person’s interest as a stockholder.”¹⁰²¹ Proper purpose is usually defined broadly by the Delaware courts, with a few exceptions.

In *City of Westland Police & Fire Retirement System v. Axcelis Technologies, Inc.*,¹⁰²² the Delaware Supreme Court provided guidance on a DGCL § 220 demand in order to determine whether a director was suitable to serve in a director position, and followed the Court of Chancery’s decision in *Pershing Square, L.P. v. Ceridian Corp.*¹⁰²³ for qualifications for inspection of books and records relating to suitability of a director:

Inspection under Section 220 is not automatic upon a statement of a proper purpose. First, a defendant may defeat demand by proving that while stating a proper purpose, plaintiff’s true or primary purpose is improper. Second, a plaintiff who states a proper purpose must also present some evidence to establish a credible basis from which the Court of Chancery could infer there are legitimate concerns regarding a director’s suitability. That is, a stockholder must establish a credible basis to infer that a director is unsuitable, thereby warranting further investigation. Third, a plaintiff must also prove that the information it seeks is necessary and essential to assessing whether a director is unsuitable to stand for reelection. Finally, access to board documents may be further limited by the need to protect confidential board communications. Thus, accepting that a desire to investigate the “suitability of a director” is a proper purpose does not necessarily expose corporations to greater risk of abuse.¹⁰²⁴

copies or extracts therefrom; or the Court may order the corporation to furnish to the stockholder a list of its stockholders as of a specific date on condition that the stockholder first pay to the corporation the reasonable cost of obtaining and furnishing such list and on such other conditions as the Court deems appropriate. Where the stockholder seeks to inspect the corporation’s books and records, other than its stock ledger or list of stockholders, such stockholder shall first establish that:

- (1) Such stockholder is a stockholder;
- (2) Such stockholder has complied with this section respecting the form and manner of making demand for inspection of such documents; and
- (3) The inspection such stockholder seeks is for a proper purpose.

Where the stockholder seeks to inspect the corporation’s stock ledger or list of stockholders and establishes that such stockholder is a stockholder and has complied with this section respecting the form and manner of making demand for inspection of such documents, the burden of proof shall be upon the corporation to establish that the inspection such stockholder seeks is for an improper purpose. The Court may, in its discretion, prescribe any limitations or conditions with reference to the inspection, or award such other or further relief as the Court may deem just and proper. The Court may order books, documents and records, pertinent extracts therefrom, or duly authenticated copies thereof, to be brought within this State and kept in this State upon such terms and conditions as the order may prescribe.

¹⁰²¹ 8 Del. C. § 220(b).

¹⁰²² *Westland Police & Fire Retirement System v. Axcelis Technologies, Inc.*, 1 A.3d 281, 282 (Del. 2010).

¹⁰²³ *Pershing Square, L.P. v. Ceridian Corp.*, 923 A.2d 810, 818 (Del. Ch. 2007).

¹⁰²⁴ *Id.* at 818.

In *Cook v. Hewlett-Packard Co.*,¹⁰²⁵ the Court of Chancery denied a stockholder request for books and records under DGCL § 220 from Hewlett-Packard Co. regarding accounting fraud at a company HP had purchased for \$11 billion. Several months after the closing HP disclosed an \$8 billion goodwill impairment in its segment that included the acquired company. Later it disclosed that it had learned of accounting improprieties by former management of the acquired company. The SEC and other governmental agencies launched investigations into the accounting improprieties. In response to the stockholders request, HP produced minutes and other records in which there were information about the acquisition, but HP declined to produce records relating to the governmental investigations. The Court found that HP had produced voluminous documents relevant to the stated purpose of the request, but that the governmental investigation information was beyond the scope of the document request and improper as it related to acquired company management pre-acquisition rather than HP management after closing. In so holding, the Court echoed some of the principles previously articulated in *Pershing Square*: (i) even if a stockholder states a proper purpose for DGCL § 220 purposes, the company may still deny a request if it can establish a different “actual” purpose; (ii) examples of improper purposes under DGCL § 220 are where (a) the true intent is to disseminate confidential data about the company and (b) the real purpose was to assist in an acquisition of the company; and (iii) the Court explained that many of the requested documents in the HP case were already produced and that the additional documents requested were not necessary for the purposes stated, noting that many requests related to actions of a company that was acquired by HP which took place *prior to* its acquisition by HP.

In *Southeastern Pennsylvania Transportation Authority v. AbbVie, Inc.*,¹⁰²⁶ the Court held that if a plaintiff’s *sole* purpose for seeking a DGCL § 220 inspection is to evaluate whether to bring derivative litigation to recover for alleged corporate wrongdoing, a proper purpose exists only to the extent the plaintiff has demonstrated a credible basis from which the court can infer wrongdoing that would not be exculpated under DGCL § 102(b)(7).

In *United Technologies v. Treppel*,¹⁰²⁷ the Delaware Supreme Court held that the Court of Chancery has the authority to limit a recipient’s use of books and records provided pursuant to DGCL § 220. The underlying action involved a stockholder who issued a books-and-records inspection request under DGCL § 220. The stockholder had previously issued a litigation demand letter to the Board relating to a U.S. Department of Justice investigation of potential federal violations committed by the corporation. The Board rejected the litigation demand, which ultimately led to the stockholder requesting books and records concerning the corporation’s evaluation of his litigation demand and the Board’s refusal to pursue litigation. The corporation agreed to allow the stockholder to inspect most of the documents he requested subject to his execution of a confidentiality agreement, which included a provision requiring any lawsuit arising out of, involving, or in connection with the inspection be brought in Delaware. The stockholder refused to bind himself to suing in Delaware. Unable to bridge the impasse, the stockholder filed his DGCL § 220 lawsuit seeking inspection of the corporation’s books and records without any usage restriction. The Supreme Court held that DGCL § 220 gives the Court of Chancery broad discretion to limit the use of books and records, including the ability to

¹⁰²⁵ C.A. No. 8667-VCG, 2014 Del. Ch. LEXIS 6, at *2 (Del. Ch. Jan. 24, 2014).

¹⁰²⁶ 2015 WL 1753033 (Del. Ch. Apr. 15, 2015).

¹⁰²⁷ 2014 Del. LEXIS 608, at *2 (Del. Dec. 23, 2014).

restrict the use of those books and records to litigation in Delaware. The Supreme Court noted that the proposed restriction on the use of books and records does not prohibit the stockholder from commencing litigation in a foreign jurisdiction, although it prohibits the stockholder from utilizing the books and records in aid of that foreign litigation.

In *Wal-Mart Stores, Inc. v. Ind. Elec. Workers Pension Trust Fund IBEW*,¹⁰²⁸ a stockholder made a books-and-records request under DGCL § 220 seeking a broad group of documents relating to an internal investigation of alleged corruption and bribery at the Delaware corporation's Mexican subsidiary the bribery allegations and the investigation, including documents created by officers as well as Board-level documents.¹⁰²⁹ The Delaware Supreme Court rejected appellant's argument that a books-and-records request should necessarily be limited to Board-level documents, holding that "the source of the documents in a corporation's possession should not control" and reaffirmed that the governing standard is whether the documents sought are "necessary and essential" to the stockholder's inspection purposes. With respect to the attorney-client privilege, the Court expressly adopted the "good cause" exception to the attorney-client privilege developed by the Fifth Circuit Court of Appeals in *Garner v. Wolfenbarger*¹⁰³⁰ as an exception to the attorney-client privilege under Delaware law.

2.9.7. Director and Officer Liability for Corporate Debts Incurred If Charter Forfeited. Directors and officers of corporations incorporated or qualified to do business in Texas may be held personally liable for debts incurred by the corporation if its corporate privileges have been forfeited for the failure to file a tax report or pay a tax or penalty.¹⁰³¹ The liability is only for

¹⁰²⁸ No. 614, 2013 (Del. July 23, 2014).

¹⁰²⁹ In *Oklahoma Firefighters Pension & Retirement System v. Citigroup, Inc.*, 2015 WL 1884453 (Del. Ch. Apr. 24, 2015), the Court found that investigating a parent for failure to monitor subsidiaries is a proper purpose, noting that plaintiff's intent is "to test whether it has viable *Caremark* claims against Citigroup's fiduciaries for failing to fulfill their oversight responsibilities" and explained that as *Caremark* cases "are among the hardest to plead successfully," the court "encourages stockholders to pursue a Section 220 demand instead of bringing a premature complaint."

¹⁰³⁰ 430 F.2d 1093, 1095 (5th Cir. 1970).

¹⁰³¹ Texas Tax Code § 171.255 (West 2015) provides as follows:

Sec. 171.255. LIABILITY OF DIRECTOR AND OFFICERS. (a) If the corporate privileges of a corporation are forfeited for the failure to file a report or pay a tax or penalty, each director or officer of the corporation is liable for each debt of the corporation that is created or incurred in this state after the date on which the report, tax, or penalty is due and before the corporate privileges are revived. The liability includes liability for any tax or penalty imposed by this chapter on the corporation that becomes due and payable after the date of the forfeiture.

(b) The liability of a director or officer is in the same manner and to the same extent as if the director or officer were a partner and the corporation were a partnership.

(c) A director or officer is not liable for a debt of the corporation if the director or officer shows that the debt was created or incurred:

(1) over the director's objection; or

(2) without the director's knowledge and that the exercise of reasonable diligence to become acquainted with the affairs of the corporation would not have revealed the intention to create the debt.

(d) If a corporation's charter or certificate of authority and its corporate privileges are forfeited and revived under this chapter, the liability under this section of a director or officer of the

debts created after the franchise tax or report is delinquent (ultimately leading for forfeiture of the corporate privileges) and before the privileges are revived; it does not result from performance of a contract entered into prior to the failure.¹⁰³² This liability includes liability to the State for sales taxes, penalties and interest owed by a fraudulent transferee from the corporation under the theory that the corporation had sold its assets to a related party in a sham transaction for the purpose of avoiding tax liability.¹⁰³³ There is a further risk of imposition of personal liability on the directors and officers of a corporation for damages resulting from breaches of contractual obligations by the corporation during such period even though the contract in question was properly entered into by the corporation prior to the due date of the report or taxes.¹⁰³⁴

2.9.8. Ratification.

(a) Texas. Ratification refers to the affirmance of a prior act done by another whereby the act is to be given effect as if done with prior authority¹⁰³⁵ and may be express or implied.¹⁰³⁶ Ratification by the principal of its agent's act relates back to the time of the act.¹⁰³⁷ Both the Board and the shareholders may ratify the actions of the corporation.

The principle is well established at common law that the Board may ratify any act or contract of any other body or agency of the corporation, such as a committee, which they might have authorized in the first place.¹⁰³⁸ In *Laird Hill Salt Water Disposal, Ltd. v. East Texas Salt Water Disposal, Inc.*, a Texas Court of Appeals held that the Board could later ratify the actions of its executive committee via a later dated resolution.¹⁰³⁹ The defendant corporation's executive committee initiated condemnation proceedings against the plaintiff before the defendant corporation's Board passed a resolution authorizing such action.¹⁰⁴⁰ The Texas Court of Appeals explained that the defendant corporation's Board could properly delegate its duties to the executive committee, including initiating condemnation proceedings, and could later ratify the

corporation is not affected by the revival of the charter or certificate and the corporate privileges.

¹⁰³² *Rossmann v. Bishop Colorado Retail Plaza, L.P.*, 455 S.W.3d 797, 802-804 (Tex. App.—Dallas 2015).

¹⁰³³ See Tex. Tax Code Ann. §§ 111.020 (West 2015) (purchaser of business may be held liable for seller's tax liability in absence of certain precautionary measures) and 111.024 (West 2010) (person acquiring business through fraudulent transfer or sham transaction is liable for taxes owed by seller); see also *Green v. State*, 324 S.W.3d 276, 279 (Tex. App.—Austin 2010, no pet.).

¹⁰³⁴ *Taylor v. First Cmty. Credit Union*, 316 S.W.3d 863, 864 (Tex. App.—Houston [14th Dist.] 2010, no pet.).

¹⁰³⁵ RESTATEMENT (THIRD) OF AGENCY: RATIFICATION DEFINED § 4.01 (2006).

¹⁰³⁶ See *First Nat'l Bank v. Wu*, 167 S.W.3d 842, 846 (Tex. App.—Houston [14th Dist.] 2005, pet. granted) (differentiating express and implied ratification).

¹⁰³⁷ *Laird Hill Salt Water Disposal, Ltd. v. East Tex. Salt Water Disposal, Inc.*, 351 S.W.3d 81, 84 (Tex. App.—Tyler 2011, pet. denied) (citing *Swain v. Wiley College*, 74 S.W.3d 143, 150 (Tex. App.—Texarkana 2002, no pet.)).

¹⁰³⁸ *Laird Hill Salt Water Disposal, Ltd. v. East Tex. Salt Water Disposal, Inc.*, 351 S.W.3d 81, 90 (Tex. App.—Tyler 2011, pet. denied) (citing *Bowers Steel, Inc. v. DeBrooke*, 557 S.W.2d 369, 371 (Tex. Civ. App.—San Antonio 1977, no writ)).

¹⁰³⁹ 351 S.W.3d at 90.

¹⁰⁴⁰ *Id.*

actions of the executive committee because it could have authorized them initially.¹⁰⁴¹ As a result, the timing of the Board’s resolution was not problematic and the defendant corporation’s actions were permissible.¹⁰⁴²

Shareholders may also ratify the actions of the Board:

[I]t is often said that shareholders “ratify” transactions between a corporation and its directors, or between the corporation and a third party in which directors have a personal interest. For example, a director would have such an interest in a contract between the corporation and another corporation in which the director serves as an officer. All of a corporation’s directors would have such an interest in a plan under which they will receive options to purchase stock issued by the corporation. Valid shareholder ratification, consisting of a vote to approve such a transaction following disclosure of the director’s interest and other material facts, binds the corporation to the transaction, in most instances without judicial assessment of its substantive merits.¹⁰⁴³

Ratification is effective, however, only when there has been full disclosure of the material facts to the shareholders.¹⁰⁴⁴

Effective September 1, 2015, the TBOC was amended to add a new Subchapter R¹⁰⁴⁵ to supplement the common law of ratification by Board or shareholder action discussed above by establishing specific non-exclusive¹⁰⁴⁶ procedures for Board, shareholder in district, court ratification of void or voidable corporate actions or share issuances. The Subchapter R provisions were modeled after DGCL §§ 204 and 205.¹⁰⁴⁷

Ratification by Board. Ratification of “defective corporate action,”¹⁰⁴⁸ including the issuance of putative shares,¹⁰⁴⁹ requires that the Board first adopt a resolution stating (a) the

¹⁰⁴¹ *Id.*

¹⁰⁴² *Id.*

¹⁰⁴³ *Id.* cmt. c.

¹⁰⁴⁴ *DeNucci v. Matthews*, No. 03-11-00680-CV, 2015 Tex. LEXIS 4041 (Tex. App.—Austin, April 23, 2015); *Lifshutz v. Lifshutz*, 199 S.W.3d 9, 21 (Tex. App.—San Antonio 2006, pet. denied) (“Transactions between corporate fiduciaries and their corporation are capable of ratification by the shareholders Ratification by any means, however, is effective only when the officer has fully disclosed all material facts of the transactions to the board of directors or shareholders.”); *First Nat’l Bank v. Wu*, 167 S.W.3d 842, 846 (Tex. App.—Houston [14th Dist.] 2005, pet. granted) (citing *Spangler v. Jones*, 861 S.W.2d 392, 394-96 (Tex. App.—Dallas 1993, writ denied) *disagreed with by Johnson & Higgins of Texas, Inc. v. Kenneco Energy, Inc.*, 962 S.W.2d 507 (Tex. 1998)); see also PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 5.02 (American Law Institute 2006); *General Dynamics v. Torres*, 915 S.W.2d 45, 50 (Tex. App.—El Paso 1995, writ denied).

¹⁰⁴⁵ TBOC §§ 21.901 – 21.917.

¹⁰⁴⁶ TBOC § 21.913.

¹⁰⁴⁷ See *infra* notes 1212-1218.

¹⁰⁴⁸ TBOC § 21.901(2) provides that “defective corporate act: means (A) an overissue; (B) an election or appointment of directors that is void or voidable due to a failure of authorizations; or (C) any act of transaction purportedly taken by or on behalf of the corporation that is, and at the time the act or transaction

defective corporate act to be ratified, (b) the time of the defective corporate act, (c) if the defective corporate act involved the issuance of putative shares, the number and type of putative shares issued and the date or dates on which the putative shares were purportedly issued, (d) the nature of the failure of authorization with respect to the defective corporate act to be ratified, and (e) that the Board approves the ratification of the defective corporate act.¹⁰⁵⁰ In the absence of actual fraud in the transaction, the ratification judgment of the Board is conclusive, unless otherwise determined by a district court in a proceeding brought under Subchapter R.¹⁰⁵¹

Shareholder Approval. The Board's ratification resolution must be submitted to shareholders for adoption if shareholder approval would have been required initially under the applicable governing documents of the corporation or any plan or agreement to which the corporation is a party.¹⁰⁵² In addition, shareholder approval will always be required if the defective corporate act results from a failure to comply with Subchapter M of TBOC Chapter 21 relating to business combination transactions with affiliated shareholders. The procedures for submission of a ratification resolution to shareholders and the voting requirements are specified in Subchapter R. Notice of the time, place (if any) and purpose of the meeting must be given at least 20 days before the date of the meeting to each holder of valid shares and putative shares, whether voting or nonvoting. In addition, notice must be given to each holder of record of valid shares¹⁰⁵³ and putative shares, regardless of whether the shares are voting or nonvoting, as of the time of the defective corporate act, except that notice is not required to be given to a holder whose identity or address cannot be ascertained from the corporation's records.¹⁰⁵⁴ The notice must contain a copy of the Board's ratification resolution and a statement of the 120 day deadline after the validation effective time¹⁰⁵⁵ for any claim that the defective corporate act ratified under Subchapter R is void or voidable due to the identified failure of authorization or any claim that the district court, in its discretion, should declare that a ratification made in accordance with Subchapter R not take effect or that it take effect only on certain conditions.¹⁰⁵⁶ The voting

was purportedly taken would have been, within the power of a corporation to take under the corporate statute, but is void or voidable due to a failure of authorization.”

¹⁰⁴⁹ TBOC § 21.901(6) provides that “‘putative shares’ means the shares of any class or series of the corporation, including shares issued on exercise of options, rights, warrants, or other securities convertible into shares of the corporation, or interests with respect to the shares that were created or issued pursuant to a defective corporate act, that (A) would constitute valid shares, if not for a failure of authorization; or (B) cannot be determined by the board of directors to be valid shares.”

¹⁰⁵⁰ Under TBOC § 21.903(a) provides that “resolution may also state that, notwithstanding adoption of the resolution by the shareholders, the Board may decide, at any time before the validation effective time, to abandon the resolution without further shareholder action.”

¹⁰⁵¹ TBOC § 21.912.

¹⁰⁵² TBOC § 21.905.

¹⁰⁵³ TBOC § 21.902(8) provides that “‘valid shares’ means the shares of any class or series of the corporation that have been authorized and validly issued in accordance with the corporate statute.”

¹⁰⁵⁴ *Id.* adding TBOC § 21.906(a) and (b).

¹⁰⁵⁵ TBOC § 21.902(9) provides that “‘validation effective time’ or ‘effective time of the validation, with respect to any effective corporate act ratified under this subchapter, means the later of (A) the time at which the resolution submitted to the shareholders for adoption under Section 21.905 is adopted by the shareholders or, if no shareholder approval is required for adoption, the time at which the notice required by Section 21.911 is given; or (B) the time at which any certificate of validation filed under Section 21.908 takes effect in accordance with Chapter 4.’”

¹⁰⁵⁶ TBOC § 21.906(c).

requirements for ratification at a shareholders meeting are the same as those applicable at the time of such adoption by the shareholders for the type of corporate act to be ratified.

Certificate of Validation. The filing of a certificate of validation with a filing officer is required if the defective corporate act being ratified would have required the filing of a filing instrument of document with the filing officer.¹⁰⁵⁷ The certificate of validation must include: (a) a copy and the date of adoption of the resolution by the Board and, if applicable, the date of adoption by the shareholders and a statement that the resolution was adopted in accordance with Subchapter R, (b) the title and date of filing of any previously filed filing instrument or document related to the defective corporate act and any certificate of correction to the filing instrument, and (c) the provisions that would be required under the TBOC to be included in the filing instrument that otherwise would have been required to be filed with respect to the defective corporate act.¹⁰⁵⁸

Effect of Ratification. On and after the validation effective time, the defective corporate act is no longer deemed void or voidable retroactive to the time of the defective corporate act.¹⁰⁵⁹ In addition, on or after the validation effective time, any putative shares purportedly issued pursuant to such defective corporate act will no longer be deemed void or voidable as a result of a failure of authorization identified in the curative resolution but will be deemed to be an identical share outstanding as of the time it was purportedly issued.¹⁰⁶⁰

Notice of Ratification to Shareholders. A notice must be given to all holders of valid shares and putative shares, whether voting or nonvoting and both as of the time of the defective corporate act and of the ratification, of the adoption of the ratifying resolution by the Board.¹⁰⁶¹ The notice must contain a copy of the resolution and a statement that the following must be brought not later than 120 days after the validation effective time: (a) any claim that the defective corporate act or putative shares ratified under Subchapter R is void or voidable due to the identified failure of authorization or (b) any claim that the district court, in its discretion, should declare that a ratification made in accordance with Subchapter R not take effect or that it take effect only on certain conditions.¹⁰⁶²

District Court Validation. A corporation, member of its Board or a shareholder may apply to a district court pursuant to TBOC § 21.914 to determine the validity and effectiveness of various matters relating to any defective corporate act or transaction or to modify or waive any of the procedures set forth in Subchapter R to ratify a defective corporate act. Actions that the district court may take as a result of the application include declaring that putative shares are valid shares, ordering the filing officer to accept an instrument for filing with a prior effective

¹⁰⁵⁷ TBOC § 21.908(a).

¹⁰⁵⁸ TBOC § 21.908(b).

¹⁰⁵⁹ TBOC § 21.909.

¹⁰⁶⁰ TBOC § 21.910.

¹⁰⁶¹ TBOC § 21.911.(a).

¹⁰⁶² TBOC § 21.911.(d).

date and time, and validating and declaring effective any defective corporate act or putative shares, among other things.¹⁰⁶³

(b) Delaware. To overturn Delaware cases holding that a void act (e.g. an *ultra vires* action or an action that does not comply with law or governing documents) cannot be ratified, and thus given retroactive sanctification and effect,¹⁰⁶⁴ the DGCL was amended effective April 1, 2014 to expressly provide that defects in stock issuances and other corporate acts render such stock and acts voidable and not void, if ratified or validated in accordance with the new ratification provisions.¹⁰⁶⁵ New DGCL § 204 provides that defective stock and defective corporate acts are not void but are voidable and may be ratified retroactive to the date the defective corporate act was originally taken or the stock originally issued, thereby curing not only the defective stock or act but also resolving the “domino effect” of such defect on subsequent corporate acts potentially resulting from a defective corporate act taken in the past.¹⁰⁶⁶ The first step in a DGCL § 204 ratification is the adoption by the Board of a resolution that states: (i) the defective corporate act to be ratified, (ii) the time of the defective corporate act, (iii) if the defective corporate act involved a share issuance, the number and type of shares and the date of issue, (iv) the nature of the failure of authorization, and (v) that the Board approves the ratification of the defective corporate act. Stockholder adoption of the ratification is required if (i) the ratified act would have required stockholder approval either at the time of the defective act or at the time the Board resolution is adopted or (ii) the defective act resulted from a failure to comply with DGCL § 203 (business combinations with interested stockholders), and would require adequate disclosure to the stockholders regarding the actions being ratified and the effect of their action.¹⁰⁶⁷ DGCL § 205 provides for situations where judicial intervention is preferable or necessary – such as when the sitting board has questionable status, and allows the Court of Chancery to “[d]eclare that a defective corporate act validated by the Court shall be effective as of the time of the defective corporate act”¹⁰⁶⁸ and to “[m]ake such other orders regarding such matters as it deems proper under the circumstances.”¹⁰⁶⁹ A defective corporate act includes “any act or transaction purportedly taken by or on behalf of the corporation that is, and at the time ... would have been, within the power of a corporation ..., but is void or voidable due to a failure of authorization.”¹⁰⁷⁰

¹⁰⁶³ TBOC § 21.914.(c).

¹⁰⁶⁴ *Triplex Shoe Co. v. Rice*, 152 A. 342, 369 (Del. 1930) (stock issued without proper consideration in violation of charter or DGCL is void; “the act was void and not merely voidable, and . . . is incapable of being cured or validated by an attempted ratification by amendment or other subsequent proceeding”); see *Starr Surgical Co. v. Waggoner*, 588 A.2d 1130, 1131 (Del. 1991); C. Stephen Bigler & Seth Barrett Tillman, *Void or Voidable? – Curing Defects in Stock Issuances Under Delaware Law*, 63 BUS. LAW. 1109 (2008).

¹⁰⁶⁵ C. Stephen Bigler and John Mark Zeberkiewicz, *Restoring Equity: Delaware’s Legislative Cure for Defects in Stock Issuances and Other Corporate Acts*, 69 BUS. LAW. 393 (2014).

¹⁰⁶⁶ *Id.*

¹⁰⁶⁷ *Cf. Gantler v. Stephens*, 965 A.2d 695, 712-13 (Del. 2009). Texas courts have also held that ratification of the results of conduct without full knowledge of the conduct cannot constitute ratification of the conduct. See *supra* note 1044 and related text.

¹⁰⁶⁸ DGCL § 205(b)(8).

¹⁰⁶⁹ DGCL § 205(b)(10).

¹⁰⁷⁰ DGCL § 204(h)(1).

In *In re Numoda Corp. S'holders Litig.*,¹⁰⁷¹ the Chancery Court determined that its power to validate a defective corporate act required first there must be a “corporate act” and explained:

Delaware law allows boards to act despite some technical defects, such as lack of notice of a board meeting. Even an *ultra vires* act can be a corporate act. However, there must be a difference between corporate acts and informal intentions or discussions. Our law would fall into disarray if it recognized, for example, every conversational agreement of two of three directors as a corporate act. Corporate acts are driven by board meetings, at which directors make formal decisions. The Court looks to organizational documents, official minutes, duly adopted resolutions, and a stock ledger, for example, for evidence of corporate acts.

The new legislation creates a flexible standard that the Court can use to fix a range of defective corporate acts, but the Court exercises its powers carefully. * * * The Court does not now draw a specific limiting bound on its powers under Section 205, but it looks for evidence of a bona fide effort bearing resemblance to a corporate act but for some defect that made it void or voidable.

The Chancery Court in *Numoda* proceeded to review the evidence presented and determine the stock ownership of the corporation by validating specified corporate acts and declining to validate others.

2.10. Transferability of Ownership Interests. The ownership interests of shareholders in a corporation are freely transferable, subject to the following restrictions discussed below:

2.10.1. Restrictions on Transfer of Shares. Shareholders of a closely-held corporation often desire to prohibit the transfer of shares to persons who are not family members or are not employees of the corporation. To be enforceable, these restrictions on transfer must be reasonable under state law. In any event, an absolute restriction on transfer would be unreasonable and therefore void.¹⁰⁷² The Tex. Corp. Stats. provide that, among other restrictions, rights of first refusal and limitations on transfer necessary to maintain S-corporation status or other tax advantages are reasonable restrictions on transfer.¹⁰⁷³ They also specify certain procedures that must be followed to assure the enforceability of the share transfer restrictions, such as the placement of a restrictive legend on stock certificates and the maintenance of a copy of the document containing the transfer restrictions at the corporation’s principal place of business or registered office.¹⁰⁷⁴ Since shares in a closely-held business typically lack an established trading market, those shares may be nontransferable as a practical matter. If the owners of the business enterprise desire to conduct an initial public offering for its shares, the corporate form of entity is the best option except in certain limited circumstances.

¹⁰⁷¹ 9163-VCN (Del. Ch. Jan. 30, 2015).

¹⁰⁷² See TBOC § 21.213; TBCA art. 2.22(C).

¹⁰⁷³ TBOC § 21.211; TBCA arts. 2.22(D), (H).

¹⁰⁷⁴ TBOC §§ 21.210, 21.213; TBCA arts. 2.22(B), (C).

2.10.2. Securities Law Restrictions. Shares in a corporation are generally considered “securities” within the meaning of federal and state securities laws. Transfers of shares are generally required to be registered under such laws absent an applicable exemption from registration.¹⁰⁷⁵

2.10.3. Beneficial Owners. The Tex. Corp. Stats. contemplate that a corporation directly communicates and deals with only a record or registered holder of its shares.¹⁰⁷⁶ It is typical, however, for publicly held shares to be held by a nominee or through securities depositories (i.e., in “street name”), so that the ultimate owner of the shares is not the record or registered holder. The TBOC was amended in the 2009 Legislative Session to provide that a corporation, if it desires, may recognize the beneficial owner as the “shareholder” and may communicate and deal directly with the beneficial owner instead of the record or registered holder.¹⁰⁷⁷ The extent of this recognition is at the corporation’s discretion: it may recognize the beneficial owner for all purposes or only for certain purposes, such as giving notice of shareholders’ meetings or paying dividends. The procedure for recognition is also subject to the corporation’s discretion, except that it must include the nominee’s filing with the corporation of a statement identifying, and providing other relevant information regarding, the beneficial owner. A beneficial owner’s decision to follow the procedure to become recognized as the “shareholder” is also subject to his or her discretion.

The TBOC was further amended in the 2009 Legislative Session to permit a beneficial owner of an ownership interest that is entitled to dissenters’ rights to file a petition for appraisal.¹⁰⁷⁸ An ownership interest is entitled to dissenters’ rights only if the record or registered owner has taken the steps in Subchapter H of TBOC Chapter 10 to perfect those rights, and a petition for appraisal may be filed only if the dissenting record or registered owner and the entity responsible for satisfying the obligations to dissenters have not agreed on the fair market value of the ownership interest. If the dissenting record or registered owner is the trustee of a voting trust or other nominee holder of the ownership interest for a beneficial owner, then the beneficial owner, as the person with the direct economic interest in the ownership interest entitled to dissenters’ rights, may pursue the dissenters’ rights by petitioning a court for appraisal. The nominee holder of the ownership interest then need not serve as plaintiff in the appraisal action.

2.10.4. No Bearer Shares. Certificates for shares in a Texas corporation may not be registered in bearer form.¹⁰⁷⁹ Bearer form certificates have no registered owners and have been criticized by federal and other law enforcement agencies as a means to avoid disclosure of actual ownership of entities in order to prevent discovery of the persons responsible for illegal activities by the culpable entity. The prohibition on bearer shares does not affect ownership interest certificates held by nominees.

¹⁰⁷⁵ See *infra* notes 1399-1402 and related text.

¹⁰⁷⁶ TBOC § 21.201.

¹⁰⁷⁷ TBOC § 21.201(b)-(d) as added in the 2009 Legislative Session by 2009 S.B. 1442 § 33.

¹⁰⁷⁸ TBOC § 10.154(c) and TBOC § 10.361(g) as added in the 2009 Legislative Session by 2009 S.B. 1442 §§ 18 and 19.

¹⁰⁷⁹ TBOC § 3.202 (f) as added in the 2009 Legislative Session by 2009 S.B. 1442 § 3. Also TBOC § 21.163(a)(4) was amended in the 2009 Legislative Session by 2009 S.B. 1442 § 31 to eliminate the ability of a corporation to issue scrip in bearer form.

2.11. Continuity of Life. Corporations frequently have perpetual existence, either by default under the TBOC or by a provision in a corporation’s articles of incorporation under older Texas law.¹⁰⁸⁰ Since a corporation is treated as a separate entity with continuity of life, events such as death or bankruptcy of an owner have no effect on the legal structure of a corporation—at least absent a specific shareholder agreement attaching consequences and procedures for certain events. Even in bankruptcy, a shareholder continues to be a shareholder of the bankrupt entity. Shares can be passed down to heirs. In contrast, under some existing non-Texas partnership laws, particularly less modern ones, a partnership is not an entity separate from its partners and a deceased partner’s estate may have to be probated in each state where the partnership owns property. Expenses and the hassle of multiple probate proceedings are avoided in a corporation because corporate shares are personal property subject to probate only in the deceased shareholder’s state of domicile.

Under the pre-TBOC business entity rules, with respect to other types of entities, the problems associated with a finite lifetime or unanticipated dissolution could be solved in many cases in the drafting of the entity’s constituent documents. However, under the TBOC, *all* domestic entities exist perpetually unless otherwise provided in its governing documents.¹⁰⁸¹ Thus, the perpetual existence of a corporation is not an advantage to be given much weight in determining the type of business entity to utilize, particularly since the TBOC governs all newly-formed entities.

2.12. Operations in Other Jurisdictions. When a corporation does business outside of its state of incorporation, it may be required to qualify to do business as a foreign corporation in the other states in which it does business under statutory provisions comparable to TBCA Part Eight and TBOC Chapter 9 and subject to taxation by those states. Over the years, there has evolved a substantial body of law for analyzing these questions.¹⁰⁸²

CHAPTER 3. GENERAL PARTNERSHIP.

3.1. General. Texas law will only recognize an association or organization as being a “partnership” if it was created under (1) the TBOC, (2) the TRPA, (3) the older Texas Uniform Partnership Act (“TUPA”),¹⁰⁸³ (4) the Texas Revised Limited Partnership Act (“TRLPA”)¹⁰⁸⁴ or (5) under a statute of another jurisdiction which is comparable to any of the Texas statutes

¹⁰⁸⁰ TBOC § 3.003; TBCA art. 3.02(A) provides that the articles of incorporation shall set forth: “(2) The period of duration, which may be perpetual.”

¹⁰⁸¹ TBOC § 3.003.

¹⁰⁸² See CT Corporation, *What Constitutes Doing Business* (2008). In the 2009 Legislative Session 2009 S.B. 1442 § 14 added a new subdivision (15) to TBOC § 9.251 (Activities Not Constituting Transacting Business in This State) to provide that mere ownership of real or personal property in Texas, without more, will not constitute transaction of business in Texas for the purposes of the requirement to register to do business under TBOC Chapter 9. For example, the ownership by a limited partner of a partnership interest in a limited partnership doing business in Texas, without more, will not require the limited partner to register to transact business in Texas. This amendment would not affect (i) the payment of taxes under the Tax Code, including the Margin Tax, or (ii) the long-arm jurisdiction statute which allows Texas courts to obtain personal jurisdiction over out-of-state entities or having sufficient minimum contacts with Texas.

¹⁰⁸³ See statutes cites *supra* note 1.

¹⁰⁸⁴ Tex. Rev. Civ. Stat. Ann. art. 6132a-1 (Vernon Supp. 2010).

referred to in (1), (2), (3), or (4) above.¹⁰⁸⁵ If an association is created under a law other than those listed, then it is not a partnership. A “partnership” is defined as an association of two or more persons to carry on a business for profit, whether they intend to create a partnership and whether they call their association a partnership, a joint venture or other name.¹⁰⁸⁶ The definition of a partnership is crucial in litigation in which a person is arguing that he is not a partner and that the general partner disadvantages (e.g., individual, and joint and several liability, for the obligations of the partnership) should not be imposed upon him.

The TBOC now governs all Texas general partnerships.¹⁰⁸⁷ Within the TBOC, Chapter 152 is specifically applicable to general partnerships, though many of the general provisions in Title 1 and Title 4, Chapters 151 and 154, will also apply. The TBOC provides that such provisions may be collectively known as “Texas General Partnership Law.”¹⁰⁸⁸ Texas general partnerships formed on or after January 1, 2006 had to be governed by the TBOC, and those formed before January 1, 2006 could voluntarily opt in to TBOC governance between January 1, 2006 and January 1, 2010.¹⁰⁸⁹ Until January 1, 2010 (at which time *all* partnerships became subject to the TBOC),¹⁰⁹⁰ Texas general partnerships which were formed prior to January 1, 2006 and did not opt into the TBOC were governed by the TRPA.¹⁰⁹¹ Because until 2010 some general partnerships were governed by the TRPA and others by the TBOC and because the substantive principles under both statutes are generally the same, the term “Tex. GP Stats.” is used herein to refer to the TBOC and the TRPA collectively, and the particular differences between the TRPA and the TBOC are referenced as appropriate.

3.1.1. Definition of “Person”. Any person may be a partner unless the person lacks capacity apart from the Tex. GP Stats. In the TBOC, “person” is defined to mean “an individual or a corporation, partnership, limited liability company, business trust, trust, association, or other organization, estate, government or governmental subdivision or agency, or other legal entity.”¹⁰⁹²

3.1.2. Factors Indicating Partnership. Under the Tex. GP Stats., the following five factors indicate that persons have created a partnership:¹⁰⁹³

- Receipt or right to receive a share of profits;

¹⁰⁸⁵ TBOC § 152.051(c); TRPA § 2.02.

¹⁰⁸⁶ TBOC § 152.051(b); TRLPA § 6(a)(1); TRPA § 2.02(a).

¹⁰⁸⁷ TBOC §§ 402.001 and 402.005.

¹⁰⁸⁸ TBOC § 1.008(f).

¹⁰⁸⁹ TBOC §§ 402.001 and 402.003.

¹⁰⁹⁰ TBOC § 402.005.

¹⁰⁹¹ TRPA § 11.03(c). Prior to January 1, 1999, some entities were still governed by the Texas Uniform Partnership Act. See TRPA § 11.03(a); Steven M. Cooper, *The Texas Revised Partnership Act and the Texas Uniform Partnership Act: Some Significant Differences*, 57 TEX. BUS. J. 828 (Sept. 1994).

¹⁰⁹² TBOC § 1.002(69-b).

¹⁰⁹³ TRPA § 2.03(a); TBOC § 152.052(a); John C. Ale & Buck McKinney, *Stumbling into Partnerships: How Bands, Business Owners and Strategic Allies Find Themselves in Inadvertent Partnerships*, 43 TEX. J. BUS. L. 465 (Fall 2009).

- Expression of an intent to be partners;
- Participation or right to participate in control of the business;
- Sharing or agreeing to share losses or liabilities; or
- Contributing or agreeing to contribute money or property to the business.

In *Ingram v. Deere*,¹⁰⁹⁴ the Supreme Court of Texas held that while “common law required proof of all five factors to establish the existence of a partnership, . . . TRPA does not require direct proof of the parties’ intent to form a partnership” and instead uses a “totality-of-the-circumstances test” in determining the existence of a partnership. The Supreme Court explained:

Whether a partnership exists must be determined by an examination of the totality of the circumstances. Evidence of none of the factors under the Texas Revised Partnership Act will preclude the recognition of a partnership, and even conclusive evidence of only one factor will also normally be insufficient to establish the existence of a partnership under TRPA. However, conclusive evidence of all five factors establishes a partnership as a matter of law. In this case, Deere has not provided legally sufficient evidence of any of the five TRPA factors to prove the existence of a partnership. Accordingly, we reverse the court of appeals’ judgment and reinstate the trial court’s take-nothing judgment.¹⁰⁹⁵

3.1.3. Factors Not Indicative of Partnership. Conversely, under Tex. GP Stats., the following circumstances do not individually indicate that a person is a partner in a business:¹⁰⁹⁶

- The right to receive or share in profits as (a) debt repayment, (b) wages or compensation as an employee or independent contractor, (c) payment of rent, (d) payment to a former partner, surviving spouse or representative of a deceased or disabled partner, (e) a transferee of a partnership interest, (f) payment of interest or (g) payment of the consideration for the sale of a business;
- Co-ownership of property whether in the form of joint tenancy, tenancy in common, tenancy by the entireties, joint property, community property or part ownership, whether combined with sharing of profits from the property;
- Sharing or having the right to share gross revenues regardless of whether the persons sharing gross revenues have a common or joint interest in the property from which they are derived; or
- Ownership of mineral property under a joint operating agreement.¹⁰⁹⁷

¹⁰⁹⁴ 288 S.W.3d 886, 895-96 (Tex. 2009).

¹⁰⁹⁵ 288 S.W.3d at 903-904 (Tex. 2009).

¹⁰⁹⁶ TRPA § 2.03(b); TBOC § 152.052(b).

3.1.4. Oral Partnerships. A written partnership agreement is not required to form a partnership: “An oral agreement of partnership is valid in Texas and need not set a specific date for termination within one year. What matters for the purpose of statute of frauds is that the partnership can be performed within a year.”¹⁰⁹⁸

¹⁰⁹⁷

The statement in TRPA § 2.03(b)(4) and TBOC § 152.052(b)(4) that “ownership of mineral property under a joint operating agreement” is not a circumstance evidencing a partnership among the co-owners is included to negate the possibility that a joint operating arrangement constitutes a “mining partnership” and to give effect to the typical operating agreement provision stating that the parties do not intend to create, and are not creating, a mining or other partnership. The law of mining partnerships is ably summarized in Cullen M. Godfrey, *Mining Partnerships: Liability Based on Joint Ownership and Operations in Texas*, XXXVII Landman 35-48 (No. 6 Nov.-Dec. 1993), which states:

The mining partnership exists by operation of law and need not be expressly intended or adopted. Interests in mining partnerships may be freely transferred without the consent of the other mining partners and neither the transfer of an interest nor the death of a partner will serve to terminate the mining partnership. Thus, drilling operations need not be interrupted or postponed due to the death of a mining partner or the transfer of a mining partner’s interest.

Mining partnerships can exist in conjunction with other defined relationships. For example, even though parties may have adopted a joint operating agreement which disclaims any partnership relationship, a mining partnership may exist nonetheless by operation of law.

* * *

The disclaimer of partnership between joint oil and gas interest owners became an accepted and trusted principle of oil and gas law. If there were any doubts about the contract provision, one only had to refer to the Texas Uniform Partnership Act, which stated that “operation of a mineral property under a joint operating agreement does not of itself establish a partnership.” The idea that no mining partnership existed in joint oil and gas operations became so well accepted that there have been very few recent mining partnership cases in Texas, and those that do exist generally support this conventional wisdom.

Notwithstanding the conventional wisdom, however, mining partnerships are being created, and they remain in existence even in the face of the standard “boiler plate” denials of partnership. If the elements of mining partnership exist, then the mining partnership exists as a matter of law without regard to the intent of the parties thereto.

Further, joint oil and gas operations are often commenced and carried out without the adoption of a joint operating agreement. When this occurs, the probability that the parties to an undocumented joint operation have created a mining partnership is significantly increased.

* * *

In order for a mining partnership to exist in Texas, five elements must be proven: (1) joint ownership, (2) joint operations, (3) sharing of profits and losses, (4) community of interests, and (5) mutual agency.

¹⁰⁹⁸

In re Wilson, 355 B.R. 600 (S.D. Tex. 2006) (citing *Niday v. Niday*, 643 S.W.2d 919 (Tex. 1982)); *see Rojas v. Duarte*, 393 S.W.3d 837 (Tex. App.—El Paso 2012, rev. denied) (two individuals found to have verbally formed a partnership under TRPA) and *Ingram v. Deere*, 288 S.W.3d 886 (Tex. 2009)); Steven A. Waters & Peter Christofferson, *Partnerships*, 61 SMU L. REV. 995, 999 n.37 (2008):

Under Texas law, the general rule is that where the parties have not fixed a time for performance and the contracted issue does not explicitly state that it cannot be performed within one year, then the contract does not fall within the statutes of frauds. *Niday*, S.W.2d at 920 (citing *Miller v. Riata Cadillac Co.*, 517 S.W.2d 773, 776 (Tex. 1974). Additionally, “where the agreement, either by its terms or by the nature of the required acts, cannot be completed within one year, it falls within the statute and must therefore be in writing.” *Niday*, 643 S.W.2d at 920 (citing *Hall v. Hall*, 308 S.W.2d 12 (Tex. 1957)).

3.1.5. Joint Ventures. The definition of a partnership under Tex. GP Stats. includes a “joint venture” or any other named association that satisfies the definition of “partnership.”¹⁰⁹⁹ A joint venture is often thought of as a limited purpose partnership, although a joint venture may be organized as a corporation, limited partnership, LLP or LLC.¹¹⁰⁰ A joint venture may also be no more than a contractual relationship such as a contractual revenue-sharing arrangement, a lease, a creditor/debtor relationship or some other relationship not constituting an entity. A risk to the contractual relationship structure is that a court will impose general partnership duties or liabilities on the venturers if their relationship is found to constitute “an association of two or more persons to operate a business as co-owners for a profit” (the traditional definition of a partnership) regardless of how the venturers characterize and document their relationship.¹¹⁰¹

Because a joint venture may be a type of partnership and loss sharing is not necessary to form a partnership, the Tex. GP Stats. effectively overrule cases in the line represented by *Coastal Plains Development Corp. v. Micrea, Inc.*¹¹⁰² They also resolve old questions about whether an agreement to share losses was necessary to create a partnership by providing that it is unnecessary.¹¹⁰³

3.2. Formation and Governing Documents. A general partnership can be one of the simplest, least expensive business entities to form because the existence of a partnership does not depend on the existence or filing of any particular document, but rather depends on the existence

¹⁰⁹⁹ TRPA § 2.02; TBOC § 152.051(b).

¹¹⁰⁰ See Byron F. Egan, *Joint Venture Formation*, 44 TEX. J. BUS. LAW 129 (2012); Alan R. Bromberg and Larry E. Ribstein, *Bromberg & Ribstein on Partnership*, § 2.06 (Aspen Publishers 2003).

¹¹⁰¹ In *Dernick Resources, Inc. v. David Wilstein, et al.*, 312 S.W.3d 864 (Tex. App.—Houston [1st Dist.] 2009, no pet.), which involved an oil and gas drilling and production arrangement pursuant to a contract that was called a “joint venture agreement,” the court in an opinion by Justice Evelyn Keyes held that the joint venture agreement created a fiduciary relationship that imposed a fiduciary duty of full and fair disclosure on the managing venturer as it held title to the venture’s properties in its name and had a power of attorney to dispose of the properties. The court explained:

Joint venturers for the development of a particular oil and gas lease have fiduciary duties to each other arising from the relationship of joint ownership of the mineral rights of the lease. [citation omitted] Likewise, if there is a joint venture between the operating owner of an interest in oil and gas well drilling operations and the non-operating interest owners, the operating owner owes a fiduciary duty to the non-operating interest owners. [citation omitted] In addition, “[a]n appointment of an attorney-in-fact creates an agency relationship,” and an agency creates a fiduciary relationship as a matter of law. [citation omitted] The scope of the fiduciary duties raised by a joint venture relationship, however, does not extend beyond the development of the particular lease and activities related to that development.

The dispute revolved around the manager’s sale of parts of its interest after giving oral notice to the other venturer, but not the written notice accompanied by full disclosure specified in the agreement. The opinion is lengthy and very fact specific, but the following lessons can be drawn from it: (i) calling a relationship a joint venture can result in a court categorizing the relationship as fiduciary, which in turn implicates duties of candor and loyalty and could implicate the common law corporate opportunity doctrine; (ii) it is important to document the relationship intended (an LLC could be used as the joint venture entity and the LLC company agreement could define or in Delaware eliminate fiduciary duties); and (iii) written agreements should be understood and followed literally.

¹¹⁰² See *Coastal Plains Dev. Corp. v. Micrea, Inc.*, 572 S.W.2d 285, 287–88 (Tex. 1978).

¹¹⁰³ TRPA § 2.03(c); TBOC § 152.052(c).

of an association of two or more persons carrying on, as co-owners, a business for profit.¹¹⁰⁴ The factors discussed above. are used to determine whether or not a general partnership exists.¹¹⁰⁵ Thus, it is not necessary that any written partnership agreement exists or that any significant expenses be incurred in the formation of a partnership.¹¹⁰⁶ Most of the time, however, partners will wish to have their relationship governed by a partnership agreement rather than rely on the default statutory provisions, and partnership agreements can be very complex.

Under Tex. GP Stats., a partnership agreement, which does not have to be in writing, governs the relations of the partners and the relations between the partners and the partnership; to the extent the partnership agreement does not otherwise provide, Tex. GP Stats. govern those relationships.¹¹⁰⁷ The partnership agreement, however, may not (i) unreasonably restrict a partner's statutory rights of access to books and records, (ii) eliminate the duty of loyalty, although the agreement may within reason identify specific types of activities that do not violate the duty of loyalty, (iii) eliminate the duty of care, although the agreement may within reason determine the standard by which the performance of the obligation is to be measured, (iv) eliminate the obligation of good faith, although the agreement may within reason determine the standard by which the performance of the obligation is to be measured, (v) vary the power to withdraw as a partner, except to require the notice be in writing, or (vi) vary certain other requirements.¹¹⁰⁸ Public policy limitations in some cases may limit the extent to which a partnership agreement may effectively reduce the fiduciary duties of a partner.

Unless the partnership agreement specifically provides otherwise, profits and losses of a general partnership are shared per capita and *not* in accordance with capital contributions or capital accounts.¹¹⁰⁹

Because partners are granted wide contractual freedom to specify the terms of their partnership, "standard" partnership agreements are less likely to be useful. Additionally, the time and expense of preparing a partnership agreement can be significant. For these reasons, the cost of organizing a general partnership is usually higher than the cost of organizing a corporation.

3.3. Owner Liability Issues. Under Tex. GP Stats.,¹¹¹⁰ and typically under common law, a general partnership as an entity is liable for loss or injury to a person, as well as for a penalty caused by or incurred as a result of a wrongful act or omission of any of its partners acting either in the ordinary course of the business of the partnership or with authority of the partnership. Generally, except as provided for an LLP (which is hereinafter discussed), all partners of a general partnership are jointly and severally liable for all debts and obligations of the partnership unless otherwise agreed by a claimant or otherwise provided by law.¹¹¹¹ Provisions in a

¹¹⁰⁴ TRPA § 2.02(a); TBOC § 152.051.

¹¹⁰⁵ TRPA § 2.03(a); TBOC § 152.052(a); *see supra* notes 1093-1097 and related text.

¹¹⁰⁶ *See Pappas v. Gounaris*, 301 S.W.2d 249, 254 (Tex. Civ. App.—Galveston 1957, writ ref'd n.r.e.).

¹¹⁰⁷ TRPA § 1.03(a); TBOC § 152.002(a).

¹¹⁰⁸ TRPA § 1.03(b); TBOC § 152.002(b).

¹¹⁰⁹ *See* TRPA § 4.01(b); TBOC § 152.202(c).

¹¹¹⁰ TRPA § 3.03; TBOC § 152.303.

¹¹¹¹ TRPA § 3.04; TBOC § 152.304.

partnership agreement that serve to allocate liability among the partners are generally ineffective against third-party creditors.¹¹¹² A partner who is, however, forced to pay more than his allocable share of a particular liability should have a right of contribution under Tex. GP Stats. from the partnership or the other partners who did not pay their allocable share.¹¹¹³

A person admitted as a new partner into an existing general partnership in Texas does not have personal liability for an obligation of the partnership that arose before his admission if the obligation relates to an action taken or omission occurring prior to his admission or if the obligation arises before or after his admission under a contract or commitment entered into before his admission.¹¹¹⁴

A general partner who withdraws from the partnership in violation of the partnership agreement is liable to the partnership and the other partners for damages caused by the wrongful withdrawal.¹¹¹⁵ A withdrawn general partner may also be liable for actions committed by the partnership while he was a partner, including malpractice, even though the action was not adjudicated to be wrongful until after the partner withdrew from the firm.¹¹¹⁶

In a change from old Texas law, a creditor under current Tex. GP Stats. must exhaust partnership assets before collecting a partnership debt from an individual partner on his or her joint and several liability, except in limited circumstances.¹¹¹⁷ Previously, a creditor could obtain a judgment enforceable against an individual partner's assets without suing the partnership.¹¹¹⁸ Generally, Tex. GP Stats. require that there be a judgment against the partnership and that the individual partner has been served in that action; however, a judgment against a partnership is not automatically a judgment against its partners.¹¹¹⁹

Even with the improvements of Tex. GP Stats., it is the unlimited liability exposure of partners in a general partnership that provides the most disadvantageous element of doing business in a the form of a general partnership.

¹¹¹² J. CARY BARTON, TEXAS PRACTICE GUIDE: BUSINESS ENTITIES § 20.205 (2003); *see Fincher v. B & D Air Conditioning & Heating Co.*, 816 S.W.2d 509, 512 (Tex. App.—Houston [1st Dist.] 1991, writ denied), *disagreed with by Kao Holdings, L.P. v. Young*, 261 S.W.3d 60 (Tex. 2008).

¹¹¹³ TRPA §§ 4.01(c), 8.06(c); TBOC §§ 152.203(d), 152.708.

¹¹¹⁴ TRPA § 3.07; TBOC § 152.304(b).

¹¹¹⁵ TRPA § 6.02(c).

¹¹¹⁶ *In re Keck, Mahin & Cate*, 274 B.R. 740, 745–47 (Bankr. N.D. Ill. 2002). In *Keck*, the court explained:

“A partner cannot escape liability simply by leaving the partnership after the malpractice is committed but before the client wins or settles a malpractice claim Courts have consistently held that, within the context of partnership dissolution, withdrawing partners remain liable for matters pending at the time of dissolution . . . [t]he general rule under Illinois law is that dissolution of the partnership does not of itself discharge the existing liability of any partners . . . partners cannot release one another from liability to [non-consenting] third parties.”

See also Molly McDonough, *Judge Orders Former Partners to Pay Creditors of Bankrupt Chicago Firm*, 1 No. 9 ABA J. E-REPORT 1 (Mar. 8, 2002) (describing reactions to the *Keck* decision).

¹¹¹⁷ TRPA § 3.05; TBOC § 152.306.

¹¹¹⁸ *See* statutes cited *supra* note 1.

¹¹¹⁹ TRPA § 3.05(c); TBOC § 152.306(a).

Under the TBOC, a judgment creditor of a partner in a general partnership may on application to a court of competent jurisdiction secure a “charging order” against the partner’s partnership interest.¹¹²⁰ In a “charging order” a court “charges” the partnership interest such that any distributions thereon are made as directed by the court, but does not order foreclosure of the interest or compel any distributions. A charging order should not permit a judgment creditor of a partner to receive distributions on an interest subject to a prior perfected security interest. The TBOC provides that a charging order is a creditor’s exclusive remedy against a general partnership interest, but that does not preclude a partner from granting a UCC security interest in a general partnership interest or a creditor from enforcing it, in each case subject to the partnership agreement. The general partnership charging order provisions are comparable to those provided by the TBOC for limited partnerships¹¹²¹ and LLCs.¹¹²²

3.4. Management. Partners have wide latitude to provide in the partnership agreement how the partnership is to be managed. Unless the partnership agreement provides otherwise, each partner has an equal right to participate in the management of the business.¹¹²³ In such a situation, management of the partnership is decentralized. Often, however, partners will designate a managing partner or partners who will have the authority to manage the business of the partnership, creating a more centralized management structure. Since a partner is an agent of the partnership, he or she may bind the partnership in the ordinary course of its business unless the partner has no authority to so act and the third party with whom the partner is dealing has knowledge that the partner has no authority to so act.¹¹²⁴ In the event that a partner exceeds his or her authority to act, the other partners may have a cause of action against such partner for

¹¹²⁰ TBOC § 152.308, as added effective September 1, 2011 by 2011 S.B. 748 § 43, reads as follows:

Sec. 152.308. PARTNER’S PARTNERSHIP INTEREST SUBJECT TO CHARGING ORDER. (a) On application by a judgment creditor of a partner or of any other owner of a partnership interest, a court having jurisdiction may charge the partnership interest of the judgment debtor to satisfy the judgment.

(b) To the extent that the partnership interest is charged in the manner provided by Subsection (a), the judgment creditor has only the right to receive any distribution to which the judgment debtor would otherwise be entitled in respect of the partnership interest.

(c) A charging order constitutes a lien on the judgment debtor’s partnership interest. The charging order lien may not be foreclosed on under this code or any other law.

(d) The entry of a charging order is the exclusive remedy by which a judgment creditor of a partner or of any other owner of a partnership interest may satisfy a judgment out of the judgment debtor’s partnership interest.

(e) This section does not deprive a partner or other owner of a partnership interest of a right under exemption laws with respect to the judgment debtor’s partnership interest.

(f) A creditor of a partner or of any other owner of a partnership interest does not have the right to obtain possession of, or otherwise exercise legal or equitable remedies with respect to, the property of the partnership.

¹¹²¹ TBOC § 153.256; *see* note 1185 and related text.

¹¹²² TBOC § 101.112; *see* note 1408 and related text.

¹¹²³ TRPA § 4.01(d); TBOC § 152.203(a).

¹¹²⁴ TRPA § 3.02; TBOC §§ 152.301, 152.302.

breach of the partnership agreement, although this does not alter the fact that the partnership may be bound by the acts of the partner that exceeded his or her authority.¹¹²⁵

3.5. Fiduciary Duties.

3.5.1. General. Under Tex. GP Stats., a partner in a general partnership owes duties of loyalty and care to the partnership, the other partners, and the heirs, legatees or personal representatives of a deceased partner to the extent of their respective partnership interests.¹¹²⁶ These duties are fiduciary in nature although not so labeled.¹¹²⁷

3.5.2. Loyalty. The duty of loyalty requires a general partner to place the interests of the partnership ahead of his own interests.¹¹²⁸ It requires a partner to account to the partnership for any partnership asset received or used by the partner and prohibits a partner from competing with the partnership or dealing with the partnership in an adverse manner. The following fact patterns may evidence a breach of the fiduciary duty of loyalty in the general partnership context on the part of general partners, creating liability to the partnership or the other partners:

- Self-dealing or profiting from dealing with the partnership in ways not contemplated by the partnership agreement;
- Appropriation of partnership opportunities;
- Refusal to distribute profits to other members of the partnership;
- Diversion of an asset of the partnership for a non-intended use;
- Failure to disclose plans and conflicts to partners; and
- A general lack of candor with partners.¹¹²⁹

¹¹²⁵ TRPA § 4.05; TBOC §§ 152.210, 152.302.

¹¹²⁶ TRPA § 4.04; TBOC § 152.204.

¹¹²⁷ See *Johnson v. Brewer & Pritchard, P.C.*, 73 S.W.3d 193, 199–200 (Tex. 2002) (asserting that since the Court historically has held that partners owe certain fiduciary duties to other partners, it did not have to consider the impact of the TRPA on such duties); Erin Larkin, *What's in a Word? The Effect on Partners' Duties after Removal of the Term "Fiduciary" in the Texas Revised Partnership Act*, 59 BAYLOR L. REV. 895 (2007).

¹¹²⁸ *Meinhard v. Salmon*, 249 N.Y. 458, 463-64, 164 N.E. 545, 546 (N.Y. 1928), in which Justice Cardozo wrote:

Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. * * * Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.

¹¹²⁹ See TRPA § 4.04(b); TBOC § 152.205; *Bromberg & Ribstein, supra* note 1100, at § 6.07.

3.5.3. Care. The duty of care requires a partner to act as an ordinarily prudent person would act under similar circumstances.¹¹³⁰ A partner is presumed to satisfy the duty of care if the partner acts on an informed basis, in good faith and in a manner the partner reasonably believes to be in the best interest of the partnership.¹¹³¹

3.5.4. Candor. In addition to the duties of loyalty and care, a partner owes his co-partners a fiduciary duty of candor, sometimes referred to as a duty of disclosure.¹¹³²

3.5.5. Liability. A partner is liable to the partnership and the other partners for violation of a statutory duty that results in harm to the partnership or the other partners and for a breach of the partnership agreement.¹¹³³ Tex. GP Stats. provide that a partner, in that capacity, is not a trustee and is not held to the same standards as a trustee,¹¹³⁴ which represents a change from cases under TUPA.¹¹³⁵ A managing partner stands in a higher fiduciary relationship to other partners than partners typically occupy.¹¹³⁶

3.5.6. Effect of Partnership Agreement. A partnership agreement governs the relations of the partners, but may not (i) unreasonably restrict a partner's statutory rights of access to books and records, (ii) eliminate the duty of loyalty, although the agreement may within reason identify specific types or categories of activities that do not violate the duty of loyalty, (iii) eliminate the duty of care, although the agreement may within reason determine the standards by which the performance of the obligation is to be measured, or (iv) eliminate the obligation of good faith, although the agreement may within reason determine the standards by which the performance of the obligation is to be measured.¹¹³⁷ In the 2013 Legislative Session, TBOC § 7.001(d)(1) was amended to provide that the liability of a partner may be limited or eliminated "in a general partnership by its partnership agreement to the same extent [TBOC § 7.001] Subsections (b) and (c) permit the limitation or elimination of liability of a governing person of an organization to which those subsections [a for-profit corporation] apply and to the additional extent permitted under" TBOC § 152.002.¹¹³⁸

3.6. Business Combinations. Texas law now authorizes a partnership to merge with a corporation, LLC or another partnership, as well as to convert from one form of entity into

¹¹³⁰ TRPA § 4.04(c); TBOC § 152.206(a).

¹¹³¹ TRPA §§ 4.04(c), (d); TBOC §§ 152.204(b), 152.206(c).

¹¹³² *Bromberg & Ribstein, supra* note 1100, at §§ 6.05(c) and 6.06.

¹¹³³ TRPA § 4.05; TBOC § 152.210.

¹¹³⁴ TRPA § 4.04(f); TBOC § 152.204(d).

¹¹³⁵ *See Huffington v. Upchurch*, 532 S.W.2d 576, 579 (Tex. 1976); *Crenshaw v. Swenson*, 611 S.W.2d 886, 890 (Tex. Civ. App.—Austin 1980, writ ref'd n.r.e.) (holding that a managing partner owes his co-partners the highest fiduciary duty recognized in the law).

¹¹³⁶ *See, e.g., Hughes v. St. David's Support Corp.*, 944 S.W.2d 423 (Tex. App.—Austin 1997, writ denied); *Conrad v. Judson*, 465 S.W.2d 819, 828 (Tex. Civ. App.—Dallas 1971, writ ref'd n.r.e.); *Huffington*, 532 S.W.2d at 579; *see also Brazosport Bank of Tex. v. Oak Park Townhouses*, 837 S.W.2d 652, 659 (Tex. App.—Houston [14th Dist.] 1992, writ granted), *rev'd on other grounds*, 851 S.W.2d 189 (Tex. 1993) (noting that a fiduciary relationship exists between general partners, as well as between general and limited partners); *Crenshaw*, 611 S.W.2d at 890.

¹¹³⁷ TRPA § 1.03(b); TBOC § 152.002; *see infra* notes 1107-1108 and related text.

¹¹³⁸ *See supra* notes 555-559 and *infra* notes 1107-1108 and related text.

another without going through a merger or transfer of assets.¹¹³⁹ Article IX of the TRPA and chapter 10 of the TBOC include provisions relating to the mechanics of adopting a plan of merger or conversion, obtaining owner approval, filing with the Secretary of State and protecting creditors.¹¹⁴⁰

3.7. Ability To Raise Capital. Since partnership interests are not freely transferable (at least with respect to management powers) and due to the unlimited liability and decentralized management features of a partnership, the partnership is not the most advantageous entity for raising capital. The general partnership, however, does have the advantage in dealing with lenders that all partners are individually liable, jointly and severally, for the partnership's debts, absent a contractual limitation of liability in the case of any particular debt.

3.8. Transferability of Ownership Interests.

3.8.1. Generally. A partnership interest is transferable by a partner, but a partner's right to participate in the management of the partnership may not be assigned without the consent of the other partners.¹¹⁴¹ Texas law differentiates between a transfer of a partner's partnership interest and the admission of a successor as a general partner. A transferee is neither able to participate in management nor liable as a partner solely because of a transfer unless and until he becomes a partner, but such transferee is entitled to receive, to the extent transferred, distributions to which the transferor would otherwise be entitled.¹¹⁴² A transfer of a partnership interest is not considered an event of withdrawal; therefore, transfer alone will not cause the winding up of the partnership business.¹¹⁴³ The partnership agreement will often contain a provision prohibiting a partner from assigning his economic rights associated with the partnership interest. Unless otherwise specified by the partnership agreement, all of the partners must consent to the substitution of a new partner.¹¹⁴⁴ General partnership interests may be evidenced by transferable certificates, but ordinarily no such certificates are issued.¹¹⁴⁵

3.8.2. Partnership Interests as Securities. Under the Securities Act of 1933, the Securities Exchange Act of 1934, and most state blue sky laws, the term "security" is defined to include an "investment contract."¹¹⁴⁶ Neither federal securities act defines a partnership interest, whether general or limited, as a "security." However, by overwhelming precedent, limited partnership interests are considered investment contracts for purposes of the securities laws.¹¹⁴⁷ The

¹¹³⁹ TRPA §§ 9.01-9.06; TBOC Chapter 10.

¹¹⁴⁰ *Id.*; TBOC §§ 10.001-10.009; 10.101-10.151; 10.154-10.201.

¹¹⁴¹ *See* TRPA § 5.03; TBOC §§ 152.401, 152.402(3).

¹¹⁴² *See* TRPA §§ 5.02, 5.03 and 5.04; TBOC §§ 152.402(3), 152.404(a), (c).

¹¹⁴³ TRPA § 5.03(a); TBOC §§ 152.402(1), (2).

¹¹⁴⁴ TRPA § 4.01(g); TBOC § 152.201.

¹¹⁴⁵ TRPA § 5.02(b); TBOC § 3.201.

¹¹⁴⁶ Securities Act of 1933, 15 U.S.C. § 77b(a)(1) (2000); Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(10) (2000).

¹¹⁴⁷ *See SEC v. Murphy*, 626 F.2d 633, 640 (9th Cir. 1980) (concluding that shares in LPs fall within the definition of "securities," as investors had no managerial role); *Stowell v. Ted S. Finkel Inv. Servs., Inc.*, 489 F. Supp. 1209, 1220 (S.D. Fla. 1980) (stating that the issue is whether the limited partnership interest meets the test of an investment contract).

question of whether a general partnership interest is a security requires a case-by-case analysis. A general partner interest may be a security when the venture, although a general partnership *de jure*, functions *de facto* as a limited partnership (i.e., certain partners do not actively participate in management and rely primarily on the efforts of others to produce profits). In *Williamson v. Tucker*,¹¹⁴⁸ the court stated that a general partnership or joint venture interest may be categorized as a security if the investor can show that:

(1) an agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership; or (2) the partner or venturer is so inexperienced and unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or (3) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers.¹¹⁴⁹

While quoting from the *Williamson* case, the *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.* court further stated that when a “partnership agreement allocates powers to the general partners that are specific and unambiguous, and when those powers are sufficient to allow the general partners to exercise ultimate control, as a majority, over the partnership and its business, then the presumption that the general partnership is not a security can only be rebutted by evidence that it is not possible for the partners to exercise those powers.”¹¹⁵⁰ The results should not be affected by the fact that some of the general partners may have remained passive¹¹⁵¹ or that the general partnership had made an LLP election.¹¹⁵²

3.9. Continuity of Life. Under Tex. GP Stats., a partnership will continue after the withdrawal of a partner or an event requiring a winding up of the business of the partnership until the winding up of the partnership has been completed.¹¹⁵³ The statutes provide for “events of withdrawal” and “events of winding up.”¹¹⁵⁴ Upon the occurrence of an event of withdrawal, the business of the partnership is not required to be wound up.¹¹⁵⁵ An event of withdrawal occurs (i) upon the occurrence of events specified in the partnership agreement, (ii) when the partnership receives notice of a partner’s election to withdraw, (iii) upon the expulsion of a partner by partner vote or judicial decree in statutorily specified circumstances, or (iv) upon the death or bankruptcy of a partner, among other events.¹¹⁵⁶ Except for the partner’s right to withdraw, the statutory events of withdrawal may be modified by the partnership agreement,¹¹⁵⁷

¹¹⁴⁸ *Williamson v. Tucker*, 645 F.2d 404, 424 (5th Cir. 1981), *cert. denied*, 454 U.S. 897 (1981).

¹¹⁴⁹ *But cf.*, *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*, 840 F.2d 236 (4th Cir. 1988).

¹¹⁵⁰ *Id.* at 241.

¹¹⁵¹ *Id.*

¹¹⁵² *Cf. SEC v. Merchant Capital, LLC*, 400 F.Supp.2d 1336 (N.D. Ga. 2005), *rev’d in part and vacated in part*, 483 F.3d 747 (11th Cir. 2007).

¹¹⁵³ TRPA §§ 2.06(a), 8.02; TBOC §§ 152.502, 152.701.

¹¹⁵⁴ TRPA §§ 1.01(6), (7); 6.01(b), 8.01; TBOC §§ 11.051, 11.057, 152.501(b).

¹¹⁵⁵ TRPA § 2.06(a), TBOC § 152.502.

¹¹⁵⁶ TRPA § 6.01; TBOC § 152.501(b).

¹¹⁵⁷ TRPA § 1.03; TBOC § 152.002.

and in view of the Check-the-Box Regulations, modification has become appropriate and common. Although a partner may withdraw from the partnership at any time, the withdrawal may subject the withdrawing partner to liability and various penalties if he or she violates the partnership agreement or the withdrawal is otherwise wrongful.¹¹⁵⁸ Unless the partnership agreement provides otherwise,¹¹⁵⁹ the interest of a withdrawing partner (except for a partner who wrongfully withdraws) must be redeemed by the partnership at fair market value.¹¹⁶⁰ An event of winding up occurs when, among other things, a majority in interest of the partners elect to wind up the partnership if the partnership does not have a specified duration, the term of the partnership expires, the partnership agreement calls for a winding up in a particular situation or all or substantially all of the assets of the partnership are sold outside the ordinary course of its business.¹¹⁶¹

3.10. Operations in Other Jurisdictions. A general partnership generally does not qualify to do business as a foreign general partnership under the laws of other states, although the partnership may have to file tax returns and the partners may be subject to taxation in the other states in which the partnership does business.¹¹⁶²

CHAPTER 4. LIMITED PARTNERSHIP.

4.1. General. A “limited partnership” is a partnership formed by two or more persons, with one or more general partners and one or more limited partners.¹¹⁶³ Limited partnerships are statutorily authorized entities. Most states have adopted some form of the Uniform Limited Partnership Act or the Revised Uniform Limited Partnership Act to govern the rights, duties and liabilities of limited partnerships organized under such statutes. In Texas, all domestic limited partnerships are now governed by the TBOC.¹¹⁶⁴ Like other entities formed under Texas law, limited partnerships formed on or after January 1, 2006 are governed by the TBOC,¹¹⁶⁵ and those formed prior to January 1, 2006 which did not voluntarily opt into the TBOC continued to be governed by the TRLPA until January 1, 2010.¹¹⁶⁶ Because from January 1, 2006 until January 1, 2010 some limited partnerships were governed by the TRLPA and others by the TBOC and because the substantive principles under both statutes are generally the same, the term “Tex. LP Stats.” is used herein to refer to the TBOC and the TRPA collectively, and the particular differences between the TRLPA and the TBOC are referenced as appropriate.

¹¹⁵⁸ TRPA § 6.02; TBOC § 152.503.

¹¹⁵⁹ TRPA § 1.03; TBOC § 152.002.

¹¹⁶⁰ TRPA § 7.01; TBOC §§ 152.601-152.602. In the case of a partner who wrongfully withdraws, the redemption price is the lesser of fair market value or liquidation value. TRPA § 7.01; TBOC §§ 152.601-152.602.

¹¹⁶¹ TRPA § 8.01; TBOC §§ 11.051, 11.057.

¹¹⁶² *Cf.* TRPA § 9.05(a) (acknowledging that the laws of other states apply to a partnership looking to be bound by that jurisdiction’s law as a domestic partnership); *see* TBOC § 10.101(d).

¹¹⁶³ TRLPA § 1.02(6); TBOC § 1.002(50).

¹¹⁶⁴ The TBOC provisions relating to limited partnerships are Title 1 and Chapters 151, 153, and 154, as well as certain provisions of Chapter 152. Such provisions may officially and collectively be referred to as “Texas Limited Partnership Law.” TBOC § 1.008(g).

¹¹⁶⁵ TBOC § 401.001.

¹¹⁶⁶ TBOC § 402.005; TRLPA § 13.10.

4.2. Formation and Governing Documents. To form a limited partnership, a certificate of formation containing (1) the name of the entity, (2) a statement that it is a limited partnership, (3) the name and address of each general partner; (4) the address of the registered office and the name and address of the registered agent for service of process; and (5) the address of the principal office where books and records are to be kept, must be filed with the Secretary of State.¹¹⁶⁷ Additionally, a filing fee of \$750 must be paid upon filing the certificate of formation.¹¹⁶⁸

The Tex. LP Stats. contain a number of default provisions that govern the limited partnership in the absence of any relevant provisions in the partnership agreement. Except as provided in the Tex. LP Stats., the partners generally have the freedom to contract around these default provisions and to provide for the rights and obligations of the partners in the partnership agreement.¹¹⁶⁹ Since the default provisions of the Tex. LP Stats. to an extent reflect the requirements of the Former Classification Regulations, attorneys drafting limited partnership agreements should now consider whether the business expectations of the partners require negation of some of the default provisions, particularly in the context of dissolution.

The Tex. LP Stats. assume the existence of a limited partnership agreement, but allow the agreement to be either written or oral.¹¹⁷⁰ An oral limited partnership agreement is subject to the statute of frauds.¹¹⁷¹

The name of the limited partnership must contain the word “limited,” the phrase “limited partnership,” or an abbreviation of either.¹¹⁷²

Unless the partnership agreement provides otherwise, unanimity is required to amend a limited partnership agreement.¹¹⁷³ Since it may be difficult to get unanimity, it may be appropriate to provide that amendments may be made with the approval of a simple majority or supermajority of the partners. If this type of provision is included, it is important to specify in the partnership agreement whether the requisite approval is based on sharing ratios, capital

¹¹⁶⁷ TBOC §§ 3.001, 3.005, 3.011. Limited partnerships formed prior to January 1, 2006 were required to file a certificate of limited partnership instead, though with substantially similar requirements for the contents. *See* TRLPA § 2.01; *see also* *Arkoma Basin Exploration Co. v. FMF Assocs.1990-A, Ltd.*, 118 S.W.3d 445, 455 (Tex. App.—Dallas 2003, judgment aff’d in part, rev’d in part, 249 S.W.3d 380 (Tex. 2008)); *Garrett v. Koepke*, 569 S.W.2d 568,569 (Tex. Civ. App.—Dallas 1978, writ ref’d n.r.e.); *Brewer v. Tehuacana Venture, Ltd.*, 737 S.W.2d 349, 352 (Tex. App.—Houston [14th Dist.] 1987, no writ).

¹¹⁶⁸ TBOC § 4.155(1).

¹¹⁶⁹ *See* TRPA § 1.03; TBOC §§ 152.002, 153.003.

¹¹⁷⁰ TRLPA § 1.02(10); TBOC § 151.001(5).

¹¹⁷¹ An oral agreement which is not to be performed within one year from the date of making of the agreement is barred by the statute of frauds. TEX. BUS. & COM. CODE ANN. § 26.01(b)(6) (Vernon Supp. 2011). *See* *Chacko v. Mathew*, 2008 WL 2390486 (Tex. App.—Houston [14th Dist.] June 12, 2008, pet. denied).

¹¹⁷² TBOC § 5.055(a). The TBOC has eliminated the TRLPA limitations on using a limited partner’s name in the name of the partnership, as well as the requirement that the necessary words or letters designating a limited partnership be at the end of the entity’s name. *See* Revisor’s Note to TBOC § 5.055. Under TRLPA § 1.03, an entity’s name had to contain the words “Limited Partnership,” “Limited,” or the abbreviation “L.P.,” “LP” (no periods) or “Ltd.” as the last words or letters of its name.

¹¹⁷³ TRPA § 4.01(i); TBOC § 152.208.

account balances, or some other factor or is merely per capita. Also, even if a majority vote is sufficient for most amendments, partnership agreements often provide that certain amendments (e.g., those that disproportionately affect a particular partner or group of partners or increases the capital commitment of partners) require a different approval (e.g., the approval of the affected partner or group of partners (or some percentage of that group of partners)). If the amendment provisions are purposefully drafted to give less than all of the partners the right to make amendments that disproportionately affect a particular partner or group of partners, it may be wise to expressly specify in the partnership agreement, to the extent permitted by the Tex. LP Stats., the ability of the general partners to act inconsistently with the fiduciary duties normally required of them.

4.3. Owner Liability Issues. A general partner of a limited partnership has the same unlimited liability as does a partner of a general partnership.¹¹⁷⁴ The Tex. LP Stats. authorize a limited partnership to register as an LLP by complying with the LLP provisions of TRPA or TBOC discussed below, whereupon the general partner would be liable for the debts or obligations of the limited partnership only to the extent provided in TRPA § 3.08(a) or TBOC § 152.801 and the limited partnership would be an “LLL.P.”¹¹⁷⁵

By contrast, a limited partner’s liability for debts of or claims against the partnership is limited to the limited partner’s capital contribution to the partnership (plus any additional amounts agreed to be contributed).¹¹⁷⁶ Veil piercing is inapplicable to Texas limited partnerships.¹¹⁷⁷ A limited partner may lose this limited liability, however, if he or she

¹¹⁷⁴ See TRLPA §§ 4.01(d), 4.03(a); TBOC § 153.152. See *KAO Holdings, L.P. v. Young*, 261 S.W.3d 60 (Tex. 2008), in which the Supreme Court of Texas held that under TRPA § 3.05(c), “while partners are generally liable for the partnership’s obligations, a judgment against the partnership is not automatically a judgment against the partner, and that judgment cannot be rendered against a partner who has not been served merely because judgment has been rendered against the partnership. The purpose of the provision is to state that service is necessary, not that it is sufficient. Partners against whom judgment is sought should be both named and served so that they are on notice of their potential liability and will have an opportunity to contest their personal liability for the asserted partnership obligation.”

¹¹⁷⁵ TRPA § 3.08(e); TRLPA § 2.14; TBOC §§ 152.805, 153.351, 153.353. See *infra* notes 1530-1535 and related text.

¹¹⁷⁶ See TRLPA § 3.03; TBOC § 153.102. The Texas LP Stats. provide that the limitation on a limited partner’s liability is not affected by the forfeiture of a limited partnership’s right to transact business in Texas because of its failure to file reports with the Secretary of State or by any resulting cancellation of its Certificate of Formation or foreign registration by the Secretary of State. TBOC §§ 153.309(c) and 153.311(d); TRLPA §§ 13.06(d) and 13.08(b). See 2009 S.B. 1442 §§ 54 and 55. See Elizabeth S. Miller, *Are There Limits on Limited Liability? Owner Liability Protection and Piercing the Veil of Texas Business Entities*, 43 TEX. J. BUS. L. 405, 426-435 (Fall 2009).

¹¹⁷⁷ See *Asshauer v. Wells Fargo Foothill*, 263 S.W.3d 468, 474 (Tex. App.—Dallas 2008, pet. denied). As such, TBCA art. 2.21 and TBOC § 21.223 make no mention of limited partners; neither the TRLPA nor the TBOC makes any effort to incorporate TBCA art. 2.21 or TBOC § 21.223 by reference; and neither the TRLPA nor the TBOC includes any provision limiting the applicability of veil piercing or alter ego theory to cases involving actual fraud. But these omissions are certainly not reflective of a legislative intent to give less protection to limited partners than to shareholders of a Texas corporation. Rather, they reflect the Legislature’s understanding that veil piercing is so clearly inapplicable to limited partnerships that to duplicate or incorporate the language of TBCA art. 2.21 would be unnecessary and inappropriate. In *Asshauer v. Wells Fargo Foothill*, veil piercing was not allowed to hold a limited partner personally liable for a partnership liability, even though the limited partnership agreement gave broad approval rights to the defendant limited partner, which was also a mezzanine lender. In so holding, the court wrote that in order

participates in the management of partnership business.¹¹⁷⁸ The safe harbor provisions of Tex. LP Stats. specify activities that will not subject a limited partner to unlimited liability, such as consulting with and advising a general partner, acting as a contractor for or an officer, agent or employee of the limited partnership (but not a director) or of a general partner, proposing, approving or disapproving certain specified matters related to the partnership business or the winding up of the partnership business or guaranteeing specific obligations of the limited partnership.¹¹⁷⁹

Even if the limited partner's activities exceed the safe harbors, the limited partner will only have unlimited liability to those third parties dealing with the limited partnership who have actual knowledge of the limited partner's participation and control and who reasonably believe that the limited partner is a general partner based on the limited partner's conduct.¹¹⁸⁰ Under the TRLPA, though not under the TBOC, a limited partner who knowingly permits his name to be used in the name of the partnership will be liable to creditors who extend credit to the limited partnership without actual knowledge that the limited partner is not a general partner.¹¹⁸¹ A corporation can serve as the general partner of a limited partnership, although the ordinary grounds for piercing the corporate veil (e.g. if the corporate general partner is not sufficiently capitalized in light of known and contingent liabilities) may be applied to hold the shareholders of such a corporate general partner liable in certain factual contexts.¹¹⁸²

4.4. Distributions. A limited partnership may not make a distribution to a partner if, immediately after giving effect to the distribution, the liabilities of the limited partnership, other than liabilities to partners with respect to their partnership interests and liabilities for which the recourse of creditors is limited to specified property of the partnership, exceed the fair value of the partnership assets.¹¹⁸³ This limitation on distributions does not apply to payments for reasonable compensation for present or past services or reasonable payments made in the ordinary course of business pursuant to a bona fide retirement plan or other benefits program.¹¹⁸⁴

Under the TBOC, a judgment creditor of a partner in a limited partnership may on application to a court of competent jurisdiction secure a "charging order" against the partner's partnership interest.¹¹⁸⁵ In a "charging order" a court "charges" the partnership interest such that

to conclude that the partnership entities should be ignored, allowing the limited partner/lender to be sued directly, simply because the limited partnerships were set up to perpetuate a fraud, they "would be required to ignore the rules of limited partnerships as set out in Texas Revised Limited Partnership Act [§ 3.03(a)] . . . [which does not provide] an exception for a limited partner to sue another limited partner or the limited partnership where the entities are allegedly part of a fraudulent scheme." TRLPA § 3.03(a) is the analogue to LLC Act § 4.03A.

¹¹⁷⁸

Id.

¹¹⁷⁹

TRLPA § 3.03(b); TBOC § 153.103.

¹¹⁸⁰

TRLPA § 3.03(a); TBOC § 153.102(b).

¹¹⁸¹

TRLPA § 3.03(d); Revisor's Note to TBOC § 153.102.

¹¹⁸²

See Grierson v. Parker Energy Partners 1984-I, 737 S.W.2d 375, 377-78 (Tex. App.—Houston [14th Dist.] 1987, no writ) (stating that in tortious activity, the corporate veil of a corporate general partner need not be pierced in order to impose liability, thus implying the veil may be pierced in other circumstances).

¹¹⁸³

TBOC § 153.210(a).

¹¹⁸⁴

TBOC § 153.210(b).

¹¹⁸⁵

TBOC § 153.256 reads as follows:

any distributions thereon are made as directed by the court, but does not order foreclosure of the interest or compel any distributions. A charging order should not permit a judgment creditor of a partner to receive distributions on an interest subject to a prior perfected security interest. The TBOC provides that a charging order is a creditor's exclusive remedy against a limited partnership interest, but that does not preclude a partner from granting a UCC security interest in a limited partnership interest or a creditor from enforcing it, in each case subject to the partnership agreement. The limited partnership charging order provisions are comparable to those provided by the TBOC for general partnerships¹¹⁸⁶ and LLCs.¹¹⁸⁷

4.5. Management. Control of a limited partnership is vested in the general partner or partners, who have all the rights and powers of a partner in a general partnership.¹¹⁸⁸ Therefore, management of a limited partnership tends to be centralized in the general partner or partners, although safe harbor provisions in most modern limited partnership statutes give limited partners greater latitude in certain matters of management of the limited partnership than was given previously.¹¹⁸⁹ Under Tex. LP Stats., the partnership agreement may provide for multiple classes or groups of limited partners having various rights or duties, including voting rights.¹¹⁹⁰ A limited partnership may have elected or appointed officers (but not directors).¹¹⁹¹

4.6. Fiduciary Duties.

4.6.1. Texas. Case law has adopted fiduciary standards for general partners of limited partnerships mirroring the unbending fiduciary standards espoused in general partnership

Sec. 153.256. PARTNER'S PARTNERSHIP INTEREST SUBJECT TO CHARGING ORDER. (a) On application by a judgment creditor of a partner or of any other owner of a partnership interest, a court having jurisdiction may charge the partnership interest of the judgment debtor to satisfy the judgment.

(b) To the extent that the partnership interest is charged in the manner provided by Subsection (a), the judgment creditor has only the right to receive any distribution to which the judgment debtor would otherwise be entitled in respect of the partnership interest.

(c) A charging order constitutes a lien on the judgment debtor's partnership interest. The charging order lien may not be foreclosed on under this code or any other law.

(d) The entry of a charging order is the exclusive remedy by which a judgment creditor of a partner or of any other owner of a partnership interest may satisfy a judgment out of the judgment debtor's partnership interest.

(e) This section does not deprive a partner or other owner of a partnership interest of a right under exemption laws with respect to the judgment debtor's partnership interest.

(f) A creditor of a partner or of any other owner of a partnership interest does not have the right to obtain possession of, or otherwise exercise legal or equitable remedies with respect to, the property of the limited partnership.

¹¹⁸⁶ TBOC § 152.308; *see supra* note 1120 and related text.

¹¹⁸⁷ TBOC § 101.112; *see infra* note 1408 and related text.

¹¹⁸⁸ TRLPA § 4.03(a); TBOC § 153.152.

¹¹⁸⁹ TRLPA § 3.03; TBOC §§ 153.102, 153.103.

¹¹⁹⁰ TRLPA § 3.02; TBOC § 154.101.

¹¹⁹¹ TBOC § 151.004.

cases.¹¹⁹² Because of their control over partnership affairs, general partners may be subjected to an even higher fiduciary standard with respect to limited partners.¹¹⁹³ Those in control of the general partner have been held to the same high standards.¹¹⁹⁴

Since a general partner in a limited partnership has the powers, duties and liabilities of a partner in a general partnership unless applicable law or the partnership agreement provides otherwise, a general partner in a limited partnership has the duties of care and loyalty set forth in TRPA section 4.04 and TBOC section 152.204,¹¹⁹⁵ which basically codify those duties without giving them the “fiduciary” appellation.¹¹⁹⁶ Since Tex. LP Stats. provide that a general partner’s

¹¹⁹² See *Hughes v. St. David’s Support Corp.*, 944 S.W.2d 423, 425–26 (Tex. App.—Austin 1997, writ denied) (holding that “in a limited partnership, the general partner stands in the same fiduciary capacity to the limited partners as a trustee stands to the beneficiaries of a trust.”); *McLendon v. McLendon*, 862 S.W.2d 662, 676 (Tex. App.—Dallas 1993, writ denied), *disapproved of by Tex. Commerce Bank, N.A. v. Grizzle*, 96 S.W.3d 240 (Tex. 2002) (holding that “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 a trust.”); *Crenshaw v. Swenson*, 611 S.W.2d 886, 890 (Tex. Civ. App.—Austin 1980, writ ref’d n.r.e.); *Watson v. Ltd. Partners of WCKT, Ltd.*, 570 S.W.2d 179, 182 (Tex. Civ. App.—Austin 1978, writ ref’d n.r.e.); Robert W. Hamilton, *Corporate General Partners of Limited Partnerships*, 1 J. SMALL & EMERGING BUS. L. 73, 73 (1997) (stating that “[g]eneral partners are personally liable for all partnership obligations, including breaches of fiduciary duties owed to the limited partners.”); see also *Huffington v. Upchurch*, 532 S.W.2d 576 (Tex. 1976); *Johnson v. Peckham*, 120 S.W.2d 786 (Tex. 1938); *Kunz v. Huddleston*, 546 S.W.2d 685 (Tex. Civ. App.—El Paso 1977, writ ref’d n.r.e.).

¹¹⁹³ In *Palmer v. Fuqua*, 641 F.2d 1146, 1155 (5th Cir. 1981), the Fifth Circuit noted that under Texas law a general partner having exclusive power and authority to control and manage the limited partnership “owe[s] the limited partners an even greater duty than is normally imposed [upon general partners].”

¹¹⁹⁴ See *In re Bennett*, 989 F.2d 779, 790 (5th Cir. 1993), *opinion amended on reh’ing*, No. 91-1059, 1993 WL 268299 (5th Cir. July 15, 1993) (explaining that when a partner is in complete control of the partnership, the partner owes the highest level of fiduciary duty); *In re USA Cafes, L.P. Litig.*, 600 A.2d 43 (Del. Ch. 1991) (in holding that directors of corporate general partner of limited partnership owe fiduciary duties to the partnership and its limited partners, the court wrote: “those 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”).

¹¹⁹⁵ TBOC § 152.204 provides as follows:

Sec. 152.204. GENERAL STANDARDS OF PARTNER'S CONDUCT. (a) A partner owes to the partnership, the other partners, and a transferee of a deceased partner's partnership interest as designated in Section 152.406(a)(2):

(1) a duty of loyalty; and

(2) a duty of care.

(b) A partner shall discharge the partner's duties to the partnership and the other partners under this code or under the partnership agreement and exercise any rights and powers in the conduct or winding up of the partnership business:

(1) in good faith; and

(2) in a manner the partner reasonably believes to be in the best interest of the partnership.

(c) A partner does not violate a duty or obligation under this chapter or under the partnership agreement merely because the partner's conduct furthers the partner's own interest.

(d) A partner, in the partner's capacity as partner, is not a trustee and is not held to the standards of a trustee.

¹¹⁹⁶ TRLPA §§ 4.03(b), 13.03; TBOC §§ 153.003, 153.152. TBOC § 153.152 provides:

conduct is not to be measured by trustee standards, it may no longer be appropriate to measure general partner conduct in terms of trustee fiduciary standards.¹¹⁹⁷ Courts, however, continue to refer to the trustee standard.¹¹⁹⁸

A general partner in a limited partnership owes the duties of care and loyalty to the partnership and the other partners.¹¹⁹⁹ The Tex. LP Stats. define the duty of care as requiring a partner to act in the conduct and winding up of the partnership business with the care of an ordinarily prudent person under similar circumstances.¹²⁰⁰ An error in judgment does not by itself constitute a breach of the duty of care.¹²⁰¹ Further, a general partner is presumed to satisfy the duty of care if the partner acts on an informed basis, in good faith and in a manner the partner reasonably believes to be in the best interest of the partnership.¹²⁰² These provisions draw on the corporate business judgment rule in articulating the duty of care. Nevertheless, Texas law does not specify whether the standard of care is one of simple or gross negligence. The sparse case law in this area (pre-dating the TRPA) indicates that a general partner will not be held liable for mere negligent mismanagement.¹²⁰³

In Texas, the duty of loyalty is defined as including:¹²⁰⁴

1. accounting to the partnership and holding for it any property, profit, or benefit derived by the partner in the conduct and winding up of the partnership business or from use by the partner of partnership property;
2. refraining from dealing with the partnership on behalf of a party having an interest adverse to the partnership; and

Sec. 153.152. GENERAL POWERS AND LIABILITIES OF GENERAL PARTNER.

(a) Except as provided by this chapter, the other limited partnership provisions, or a partnership agreement, a general partner of a limited partnership:

- (1) has the rights and powers and is subject to the restrictions of a partner in a partnership without limited partners; and
- (2) has the liabilities of a partner in a partnership without limited partners to the partnership and to the other partners.

(b) Except as provided by this chapter or the other limited partnership provisions, a general partner of a limited partnership has the liabilities of a partner in a partnership without limited partners to a person other than the partnership and the other partners.

See Erin Larkin, What's in a Word? The Effect on Partners' Duties after Removal of the Term "Fiduciary" in the Texas Revised Partnership Act, 59 BAYLOR L. REV. 895 (2007).

¹¹⁹⁷ TRPA § 4.04(f); TBOC § 152.204(d).

¹¹⁹⁸ *See McBeth v. Carpenter*, 565 F.3d 171 (C.A.5 (Tex. 2009)); *Hughes v. St. David's Support Corp.*, 944 S.W.2d 423, 425-26 (Tex. App.—Austin 1997, writ denied).

¹¹⁹⁹ TRPA § 4.04(a); TBOC § 152.204(a).

¹²⁰⁰ TRPA § 4.04(c); TBOC § 152.206(a).

¹²⁰¹ TRPA § 4.04(c); TBOC § 152.206(a).

¹²⁰² TRPA § 4.04(c)-(d); TBOC §§ 152.204(b), 152.206.

¹²⁰³ *See Ferguson v. Williams*, 670 S.W.2d 327, 331 (Tex. App.—Austin 1984, writ ref'd n.r.e.).

¹²⁰⁴ TRPA § 4.04(b); TBOC § 152.205.

3. refraining from competing with the partnership or dealing with the partnership in a manner adverse to the partnership.

These provisions in the Tex. LP Stats. mirror the common areas traditionally encompassed by the duty of loyalty (e.g., self-dealing, conflicts of interest and usurpation of partnership opportunity).¹²⁰⁵ To temper some of the broader expressions of partner duties in older Texas case law and permit a balancing analysis as in the corporate cases, Texas law specifically states that a partner does not breach a duty merely because his conduct furthers his own interest and that the trustee standard should not be used to test general partner conduct.¹²⁰⁶ It does, however, impose on a general partner in a limited partnership the obligation to discharge any duty, and exercise any rights or powers, in conducting or winding up partnership business in good faith and in a manner that the partner reasonably believes to be in the best interest of the partnership.¹²⁰⁷

Under the TBOC *limited* partners, as limited partners, generally do not owe fiduciary duties to the partnership or to other partners.¹²⁰⁸ Previously, a literal reading of the TRPA and TRLPA suggested that limited partners owed such duties by virtue of the linkage of TRPA to TRLPA under TRLPA section 13.03(a).¹²⁰⁹ That literal interpretation of the statutes, however, was contrary to the general concept that limited partners are merely passive investors and thus should not be subjected to liability for their actions as limited partners. Further, even before the TBOC was enacted there was some case law to the effect that limited partners do not have fiduciary duties.¹²¹⁰ Pre TBOC, an exception was made to this general rule in the case where a limited partner actually had or exercised control in management matters (e.g., because of control of the general partner, contractual veto powers over partnership actions or service as an agent of

¹²⁰⁵ Under Texas law, persons engaged in a partnership owe to one another one of the highest duties recognized in law—the duty to deal with one another with the utmost good faith and most scrupulous honesty. *See Huffington v. Upchurch*, 532 S.W.2d 576, 579 (Tex. 1976); *Smith v. Bolin*, 271 S.W.2d 93, 96 (Tex. 1954); *Johnson v. J. Hiram Moore, Ltd.*, 763 S.W.2d 496, 497 (Tex. App.—Austin 1988, writ denied); *see also Brazosport Bank of Tex. v. Oak Park Townhouses*, 837 S.W.2d 652, 659 (Tex. App.—Houston [14th Dist.] 1992, writ granted), *rev'd on other grounds*, 851 S.W.2d 189 (Tex. 1993); *Crenshaw v. Swenson*, 611 S.W.2d 886, 890 (Tex. Civ. App.—Austin 1980, writ ref'd n.r.e.).

¹²⁰⁶ TRPA § 4.04(e)-(f); TBOC § 152.204(c)-(d).

¹²⁰⁷ TRPA § 4.04(d); TBOC § 152.204(b).

¹²⁰⁸ TBOC §§ 153.003(b) (“The powers and duties of a limited partner shall not be governed by a provision of Chapter 152 [the TBOC Chapter dealing with general partnerships] that would be inconsistent with the nature and role of a limited partner as contemplated by this chapter [153]”) and 153.003(c) (“A limited partner shall not have any obligation or duty of a general partner solely by reason of being a limited partner”).

¹²⁰⁹ TRLPA § 13.03(a) provides: “In any case not provided by [TRLPA], the applicable statute governing partnerships that are not limited partnerships [TRPA] and the rules of law and equity, including the law merchant, govern.”

¹²¹⁰ *See, e.g., Strebel v. Wimberly II*, 311 S.W.3d 267 (Tex. App.—Houston [1st Dist.] 2012) *pet. filed*; *In re Villa West Assocs.*, 146 F.3d 798, 806 (10th Cir. 1998); *In re Kids Creek Partners, L.P.*, 212 B.R. 898, 937 (Bankr. N.D. Ill. 1997).

the partnership).¹²¹¹ In such situations, the limited partner's conduct could be judged by fiduciary principles.¹²¹²

The Tex. LP Stats. state in part that except as provided in various statutory provisions or the partnership agreement, a general partner of a limited partnership “has the liabilities of a partner in a partnership without limited partners to the partnership and to the other partners.”¹²¹³ This language indicates that the partnership agreement may modify the internal liabilities of a general partner. Although there are questions whether it is an authorization without express limits or whether it would link to Texas general partnership statutes that prohibit elimination of duties and set a “manifestly unreasonable” floor for contractual variation,¹²¹⁴ in *Strebel v.*

¹²¹¹ *McBeth v. Carpenter*, 565 F.3d 171 (5th Cir. 2009) (limited partnerships controlled by the same individual who controlled the general partner, and whose individual conduct was held to violate his fiduciary duties to the limited partners, were held to have fiduciary duties to the other limited partners).

¹²¹² *See RJ Assocs., Inc. v. Health Payors' Org. Ltd. P'ship, HPA, Inc.*, No. 16873, 1999 WL 550350, at *10 (Del. Ch. July 16, 1999) (unpublished mem. op.) (suggesting that, unless a partnership agreement provides to the contrary, any limited partner owes fiduciary duties to the partnership); *KE Prop. Mgmt. Inc. v. 275 Madison Mgmt. Inc.*, Civ. A. No. 12683, 1993 WL 285900, at *4 (Del. Ch. July 27, 1993). Limited partners who function as officers or managers of a limited partnership are typically considered agents of the limited partnership, and as agents to owe fiduciary duties, including the duty of loyalty, to the limited partnership and its other partners. *See* RESTATEMENT (SECOND) OF THE LAW OF AGENCY (1958) §§ 13 (“An agent is a fiduciary with respect to matters within the scope of his agency”), 387 (“Unless otherwise agreed, an agent is subject to a duty to his principal to act solely for the benefit of the principal in all matters connected with his agency”), 393 (“Unless otherwise agreed, an agent is subject to a duty not to compete with the principal concerning the subject matter of his agency”), 394 (“Unless otherwise agreed, an agent is subject to a duty not to act or to agree to act during the period of his agency for persons whose interests conflict with those of the principal in matters in which the agent is employed”), and 395 (“Unless otherwise agreed, an agent is subject to a duty to the principal not to use or to communicate information confidentially given him by the principal or acquired by him during the course of or on account of his agency or in violation of his duties as agent, in competition with or to the injury of the principal, on his own account or on behalf of another, although such information does not relate to the transaction in which he is then employed, unless the information is a matter of general knowledge”); *see also Daniel v. Falcon Interest Realty Corp.*, 190 S.W.3d 177, 180 (Tex. App.—Houston [1st Dist.] 2005, no pet.).

¹²¹³ TRLPA § 4.03(b); TBOC § 153.152(a). This language should *not* be mistaken as an authorization for partnership agreements to alter partner liabilities to third parties. *See infra* notes 1461-1557 and related text regarding the LLP provisions in TRPA and the TBOC which permit a general partnership to significantly limit the individual liability of its partners for certain acts of other partners by the partnership making a specified LLP filing with the Secretary of State and complying with the other requirements of the Tex. LLP Stats.

The implied contractual duty of good faith and fair dealing is likely a duty of a general partner, in addition to the general partner's fiduciary duties. *See Dunnagan v. Watson*, 204 S.W. 3d 30 (Tex. App.—Ft. Worth 2006, *pet. denied*); RESTATEMENT (SECOND) OF CONTRACTS § 205 (“every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement”). This contractual duty of good faith and fair dealing is to be contrasted with the fiduciary duty of good faith, which is a component of the common law fiduciary duty of loyalty. *See also infra* note 1332.

¹²¹⁴ *See* TRPA § 1.03(b); TBOC § 152.002(b). “Partnership agreement” is defined to be either a written *or oral* agreement of the partners concerning the affairs of the partnership and the conduct of its business. *See* TRLPA § 1.02(10); TBOC § 151.001(5) (emphasis added).

Some TRLPA provisions permit modification by either a written or oral partnership agreement, while others require the modification to be in the form of a written partnership agreement. *Compare* TRLPA § 4.03(a) and TBOC § 153.152 concerning restrictions on a general partner *with* TRLPA § 11.02 and TBOC § 8.103(c) concerning indemnification of a general partner.

*Wimberly II*¹²¹⁵ the Court denied a limited partner’s claims for general partner breach of fiduciary duty on the basis of a limited partnership agreement provision that “the General Partner shall have no duties (including fiduciary duties) except as expressly set forth in this Agreement.” In the 2013 Legislative Session, TBOC § 7.001(d)(2) was amended to provide that the liability of a general partner may be limited or eliminated “in a limited partnership by its partnership agreement to the same extent [TBOC § 7.001] Subsections (b) and (c) permit the limitation or elimination of liability of a governing person of an organization to which those subsections apply [a for-profit corporation] and to the additional extent permitted under Chapter 153 and, to the extent applicable to limited partnerships, Chapter 152.”¹²¹⁶

Under the Tex. LP Stats., the duties of care and loyalty and the obligation of good faith may not be eliminated by the partnership agreement, but the statute leaves room for some modification by contract.¹²¹⁷ For example, the partnership agreement may not eliminate the duty of care, but may determine the standards by which the performance of the obligation is to be measured, if the standards are not “manifestly unreasonable.”¹²¹⁸ In one case decided prior to the passage of the TRPA and the TBOC, the Court stated that, when the parties bargain on equal terms, a fiduciary may contract for the limitation of liability, though public policy would preclude limitation of liability for self-dealing, bad faith, intentional adverse acts, and reckless indifference with respect to the interest of the beneficiary.¹²¹⁹

With respect to a partner’s duty of loyalty, Tex. LP Stats. provide that the partnership agreement may not eliminate the duty of loyalty, but may identify specific types or categories of activities that do not violate the duty of loyalty, again if not “manifestly unreasonable.”¹²²⁰ The level of specificity required of provisions in the partnership agreement limiting duties pursuant to Tex. LP Stats. is unknown. In fact, it may depend upon the circumstances, such as the sophistication and relative bargaining power of the parties, the scope of the activities of the partnership, etc.

Tex. LP Stats. provide that the obligation of good faith may not be eliminated by the partnership agreement, but the agreement may determine the standards by which the performance is to be measured if not “manifestly unreasonable.”¹²²¹ Again the parameters of this provision are not readily apparent and probably will depend, at least in part, on the circumstances of any particular case.

Texas law requires a limited partnership to keep in its registered office, and make available to the partners for copying and inspection, certain minimum books and records of the partnership.¹²²² This mandate provides a statutory mechanism by which a partner may obtain the documents specified therein, but should not be viewed as in any way limiting a general partner’s

¹²¹⁵ 371 S.W.3d 267 (Tex. App.—Houston [1st Dist.] 2012, pet. denied).

¹²¹⁶ See supra note 1138 and related text

¹²¹⁷ TRLPA §§ 4.03(b), 13.03(a); TRPA §§ 1.03(b), 4.04; TBOC §§ 152.002(b); 153.003(a).

¹²¹⁸ TRLPA §§ 4.03(b), 13.03(a); TRPA §§ 1.03(b)(3), 4.04; TBOC § 152.002(b)(3).

¹²¹⁹ *Grider v. Boston Co., Inc.*, 773 S.W.2d 338, 343 (Tex. App.—Dallas 1989, writ denied).

¹²²⁰ TRLPA §§ 4.03(b), 13.03(a); TRPA §§ 1.03(b)(2), 4.04; TBOC §§ 152.002(b)(2), 153.003(a).

¹²²¹ TRLPA §§ 4.03(b), 13.03(a); TRPA §§ 1.03(b)(4), 4.04; TBOC §§ 152.002(b)(4), 153.003(a).

¹²²² TRLPA § 1.07; TBOC §§ 153.551, 153.552.

broader fiduciary duty of candor regarding partnership affairs as developed in case law and as provided in Tex. LP Stats.¹²²³

4.6.2. Delaware. Delaware concepts of general partner fiduciary duties generally parallel Texas law, and are framed in the Delaware statutes.¹²²⁴ Delaware, however, expressly allows the limitation or elimination of partner fiduciary duties in the partnership agreement, but expressly does not allow the elimination of the implied contractual covenant of good faith and fair dealing which Delaware recognizes in all partnership agreements.¹²²⁵ Although limitations on fiduciary

¹²²³ See TRPA § 4.03; TBOC §§ 153.551, 153.552.

¹²²⁴ The duties of a partner in a Delaware general partnership are set forth in Section 15-404 of the Delaware Revised Uniform Partnership Act (“DRPA”). Section 15-404(a)-(d) of DRPA provides as follows:

§ 15-404. General standards of partner’s conduct.

(a) The only fiduciary duties a partner owes to the partnership and the other partners are the duty of loyalty and the duty of care set forth in subsections (b) and (c) of this section.

(b) A partner’s duty of loyalty to the partnership and the other partners is limited to the following:

(1) To account to the partnership and hold as trustee for it any property, profit or benefit derived by the partner in the conduct or winding up of the partnership business or affairs or derived from a use by the partner of partnership property, including the appropriation of a partnership opportunity;

(2) To refrain from dealing with the partnership in the conduct or winding up of the partnership business or affairs as or on behalf of a party having an interest adverse to the partnership; and

(3) To refrain from competing with the partnership in the conduct of the partnership business or affairs before the dissolution of the partnership.

(c) A partner’s duty of care to the partnership and the other partners in the conduct and winding up of the partnership business or affairs is limited to refraining from engaging in grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law.

(d) A partner does not violate a duty or obligation under this chapter or under the partnership agreement solely because the partner’s conduct furthers the partner’s own interest.

Section 17-403(a) of the Delaware Revised Limited Partnership Act (“DRLPA”), makes the DRPA § 15-404 fiduciary duties applicable to the general partner of a limited partnership as follows:

§ 17-403. General powers and liabilities.

(a) Except as provided in this chapter or in the partnership agreement, a general partner of a limited partnership has the rights and powers and is subject to the restrictions of a partner in a partnership that is governed by the Delaware Uniform Partnership Law in effect on July 11, 1999 (6 Del. C. § 1501 et seq.).

¹²²⁵ Section 17-1101(b)-(f) of DRLPA provides as follows:

(b) The rule that statutes in derogation of the common law are to be strictly construed shall have no application to this chapter.

(c) It is the policy of this chapter to give maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements.

(d) To the extent that, at law or in equity, a partner or other person has duties (including fiduciary duties) to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement, the partner's or other person's duties may be expanded or restricted or eliminated by provisions in the partnership agreement; provided that the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing.

(e) Unless otherwise provided in a partnership agreement, a partner or other person shall not be liable to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement for breach of fiduciary duty for the partner's or other person's good faith reliance on the provisions of the partnership agreement.

(f) A partnership agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a partner or other person to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement; provided, that a partnership agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.

See RESTATEMENT (SECOND) OF CONTRACTS § 205 (“every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement”). This contractual duty of good faith and fair dealing is to be contrasted with the fiduciary duty of good faith, which is a component of the common law fiduciary duty of loyalty. *See Stone v. Ritter*, 911 A.2d 362 (Del. 2006); Byron F. Egan, *How Recent Fiduciary Duty Cases Affect Advice to Directors and Officers of Delaware and Texas Corporations* at 13-15 and 435-443, University of Texas School of Law 36th Annual Conference on Securities Regulation and Business Law (Feb. 14, 2014), available at <http://www.jw.com/publications/article/1945>.

See Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 DEL. J. CORP. L. 1, 25 (2007), in which Delaware Supreme Court Chief Justice Steele argues that parties forming limited partnerships and companies should be free to adopt or reject some or all of the fiduciary duties recognized at common law in the context of corporations, that courts should look to the parties' agreement and apply a contractual analysis, rather than analogizing to traditional notions of corporate governance, in limited partnership and LLC fiduciary duty cases, and that Delaware courts should analyze limited partnership fiduciary duty cases as follows:

The courts' approach should be, first, to examine the agreement to determine if the act complained of is legally authorized by statute or by the terms of the agreement itself. If so, a court should then proceed to inquire whether the implementation of the lawful act requires equity to intervene and craft a remedy? At this point, the court should look to the agreement to determine the extent to which it establishes the duties and liabilities of the parties, i.e., their bargained for, negotiated, contractual relationship. Is the agreement silent about traditional fiduciary duties, but creates a fiduciary relationship consistent with those duties thus allowing the court to imply them by default? Does the agreement expand, restrict, or eliminate one or more of the traditional fiduciary duties? Is the contract language creating those duties and liabilities so inconsistent with common law fiduciary duty principles that it can be concluded that the parties consciously modified them in a discernible way? If so, which duties and in what respect were they modified? Finally, without regard to traditional overlays of scrutiny under the common law of corporate governance, has a party breached its implied covenant of good faith and fair dealing?

See infra note 1350 regarding Chief Justice Steele's views in respect of fiduciary duties in the LLC context.

duty in a partnership agreement may be respected by courts when they are expressly set forth in the four corners of the partnership agreement, “a topic as important as this should not be addressed coyly.”¹²²⁶

¹²²⁶ *Miller v. Am. Real Estate Partners, L.P.*, C.A. No. 16788, 2001 WL 1045643, at *8 (Del. Ch. Sept. 6, 2001) (unpublished mem. op.). In *Miller*, the general partner contended that the partnership agreement eliminated any default fiduciary duty of loyalty owed by the general partner to the limited partners in section 6.13(d) of the partnership agreement, which read as follows:

Whenever in this Agreement the General Partner is permitted or required to make a decision (i) in its “sole discretion” or “discretion”, with “absolute discretion” or under a grant of similar authority or latitude, the General Partner shall be entitled to consider only such interests and factors as it desires and shall have no duty or obligation to give any consideration to any interest of or factors affecting the Partnership, the Operating Partnership or the Record Holders, or (ii) in its “good faith” or under another express standard, the General Partner shall act under such express standard and shall not be subject to any other or different standards imposed by this Agreement or any other agreement contemplated herein.

In finding that the foregoing provision was not adequate to eliminate the general partner’s fiduciary duty of loyalty, Vice Chancellor Strine wrote:

This is yet another case in which a general partner of a limited partnership contends that the partnership agreement eliminates the applicability of default principles of fiduciary duty, and in which this court finds that the drafters of the agreement did not make their intent to eliminate such duties sufficiently clear to bar a fiduciary duty claim. Here, the drafters of the American Real Estate Partners, L.P. partnership agreement did not clearly restrict the fiduciary duties owed to the partnership by its general partner, a defendant entity wholly owned by defendant Carl Icahn. Indeed, the agreement seems to contemplate that the general partner and its directors could be liable for breach of fiduciary duty to the partnership if they acted in bad faith to advantage themselves at the expense of the partnership.

* * *

Once again, therefore, this court faces a situation where an agreement which does not expressly preclude the application of default principles of fiduciary is argued to do so by implication. Indeed, this case presents the court with an opportunity to address a contractual provision similar to the one it interpreted on two occasions in *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, and contemporaneously with this case in *Gelfman v. Weeden Investors, L.P.* In each of those cases, this court held that the traditional fiduciary entire fairness standard could not be applied because it was inconsistent with a contractual provision providing a general partner with sole and complete discretion to effect certain actions subject solely to a contract-specific liability standard. The court’s decision was based on two factors. First, the court noted the difference between the sole and complete discretion standard articulated in the agreements, which explicitly stated that the general partner had no duty to consider the interests of the partnership or the limited partner in making its decisions, and the traditional notion that a fiduciary acting in a conflict situation has a duty to prove that it acted in a procedurally and substantively fair manner. Second, and even more critically, however, each of the agreements indicated that when the sole and complete discretion standard applied, any other conflicting standards in the agreements, other contracts, or under law (including the DRULPA) were to give way if it would interfere with the general partners’ freedom of action under the sole and complete discretion standard. That is, in each case, the agreement expressly stated that default principles of fiduciary duty would be supplanted if they conflicted with the operation of the sole and complete discretion standard.

Five Delaware Supreme Court decisions issued between May 20, 2013 and August 26, 2013 involving transactions by an LP with a related party address the effectiveness of contractual provisions in a limited partnership agreement (“LPA”) that modify or eliminate default fiduciary duties and substitute therefor contractual “safe harbors” to cleanse conflicted transactions.¹²²⁷ These five opinions can be viewed as a roadmap to the wording, pitfalls and alternatives to be considered when structuring M&A transactions involving alternative entities.¹²²⁸

Four of these recent decisions reaffirm the effectiveness of such provisions that modify or eliminate default fiduciary duties and substitute therefor contractual “safe harbors” to cleanse conflicted transactions. The fifth decision illustrates that the implied contractual covenant of good faith and fair dealing (which parties may not contractually eliminate) can provide the basis

This case presents a twist on *Gotham Partners* and *Gelfman*. Like the provisions in *Gotham Partners* and *Gelfman*, § 6.13(d) sets forth a sole discretion standard that appears to be quite different from the duty of a fiduciary to act with procedural and substantive fairness in a conflict situation. What is different about § 6.13(d), however, is that it does not expressly state that default provisions of law must give way if they hinder the General Partner’s ability to act under the sole discretion standard. Rather, § 6.13(d) merely states that other standards in the Agreement or agreements contemplated by the agreement give way to the sole discretion standard. By its own terms, § 6.13(d) says nothing about default principles of law being subordinated when the sole discretion standard applies.

* * *

This court has made clear that it will not be tempted by the piteous pleas of limited partners who are seeking to escape the consequences of their own decisions to become investors in a partnership whose general partner has clearly exempted itself from traditional fiduciary duties. The DRULPA puts investors on notice that fiduciary duties may be altered by partnership agreements, and therefore that investors should be careful to read partnership agreements before buying units. In large measure, the DRULPA reflects the doctrine of *caveat emptor*, as is fitting given that investors in limited partnerships have countless other investment opportunities available to them that involve less risk and/or more legal protection. For example, any investor who wishes to retain the protection of traditional fiduciary duties can always invest in corporate stock.

But just as investors must use due care, so must the drafter of a partnership agreement who wishes to supplant the operation of traditional fiduciary duties. In view of the great freedom afforded to such drafters and the reality that most publicly traded limited partnerships are governed by agreements drafted exclusively by the original general partner, it is fair to expect that restrictions on fiduciary duties be set forth clearly and unambiguously. A topic as important as this should not be addressed coyly.

¹²²⁷ The five decisions in order of opinion date are: *Brinckerhoff v. Enbridge Energy Co.*, 67 A.3d 369, 370 (Del. May 28, 2013); *Norton v. K-Sea Transportation Partners L.P.*, 67 A.3d 354, 356 (Del. May 28, 2013); *Gerber v. Enter. Prods. Hldgs., LLC*, 67 A.3d 400, 404 (Del. June 10, 2013); *Allen v. Encore Energy Partners, L.P.*, 72 A.3d 93, 95 (Del. July 22, 2013); and *DV Realty Advisors LLC v. Policemen’s Annuity and Benefit Fund of Chicago*, No. 547, 2012, 2013 WL 4517001 (Del. August 26, 2013). See Thomas A. Mullen and Janine M. Salomone, *Delaware Insider: MLPs Take Center Stage in the Delaware Supreme Court*, BUS. L. TODAY 37, Vol. 22, Issue 12 (Aug. 2013).

¹²²⁸ “Alternative entities” are unincorporated entities, including general and limited partnerships and limited liability companies, in which the relationships among the key players can be defined by contract under the applicable Delaware statutes, which provide that common law fiduciary duties may be limited or eliminated in a partnership or limited liability company agreement.

for challenging an unfair M&A transaction even where default fiduciary duties have been clearly eliminated in the LPA.¹²²⁹

In *Allen v. Encore Energy Partners, L.P.*,¹²³⁰ a case involving a merger of a publicly traded limited partnership (“MLP”) with its general partner’s ultimate parent (its “controller”), a limited partner alleged that the general partner, its controller and its directors breached the contractual duties imposed by the LPA in connection with the merger. The Supreme Court confirmed the enforceability of clear, express and unambiguous language in an LPA replacing default fiduciary duties with a contractual duty that would be satisfied if the transaction at issue was approved in “good faith” (as defined by the LPA) by the Conflicts Committee of independent directors on the general partner’s Board. The LPA replaced common law fiduciary duties with a contractually adopted duty of “subjective good faith” and deemed this contractual duty to be satisfied if a Committee of independent directors of the general partner’s Board grants “Special Approval” to a transaction, so long as the independent directors themselves act with subjective good faith.¹²³¹ The Court concluded that the contractual “good faith” standard under the LPA required only a subjective belief that the determination or other action is in the best interests of the limited partnership:

The LPA’s contractual duty require[d] a “belie[f] that the determination or other action is in the best interests of the Partnership.” *Black’s Law Dictionary* defines *believe* as “[t]o feel certain about the truth of; to accept as true,” whereas it defines *reasonably believe* as “[t]o believe (a given fact or combination of facts) under circumstances in which a reasonable person would believe.” Some LPA provisions use “reasonably believes,” while others use “believes,” indicating that the parties intentionally distinguished between those two standards. Therefore, we conclude that the Vice Chancellor correctly defined this LPA’s contractual duty of good faith when he stated that “an act is in good faith if the actor *subjectively believes* that it is in the best interests of the Partnership.” This definition distinguishes between “reasonably believes” and “believes” and eschews an objective standard when interpreting the unqualified term “believes.”

¹²²⁹ *Gerber v. Enter. Prods. Hldgs., LLC*, 67 A.3d 400, 404 (Del. June 10, 2013).

¹²³⁰ 72 A.3d 93, 95 (Del. July 22, 2013).

¹²³¹ Taking advantage of DRULPA’s flexibility, the LPA provided:

Except as expressly set forth in [the LPA], *neither [general partner] nor any other Indemnitee [an affiliate of the general partner] shall have any duties or liabilities, including fiduciary duties, to the Partnership or any Limited Partner . . . and the provisions of [the LPA], to the extent that they restrict, eliminate or otherwise modify the duties and liabilities, including fiduciary duties, of [general partner] or any other Indemnitee otherwise existing at law or in equity, are agreed by the Partners to replace such other duties and liabilities of [general partner] or such other Indemnitee.*

Additional relevant provisions from the LPA involved in *Allen v. Encore Energy Partners, L.P* are quoted in note 1492 on pages 439-440 of Byron F. Egan, *How Recent Fiduciary Duty Cases Affect Advice to Directors and Officers of Delaware and Texas Corporations*, University of Texas School of Law 36th Annual Conference on Securities Regulation and Business Law (Feb. 14, 2014), available at <http://www.jw.com/publications/article/1945>.

Thus, to avoid the granting of defendants' motion to dismiss, the plaintiff would have to adequately plead either that (i) the Conflicts Committee of the general partner's Board believed it was acting against the limited partnership's best interests when approving the merger or (ii) the Conflicts Committee consciously disregarded its duty to form a subjective belief that the merger was in the limited partnership's best interests. The Supreme Court observed that it would likely take an extraordinary set of facts to meet such a pleading burden and that plaintiff had failed to do so, but noted that plaintiff had not pled that defendant's conduct did not conform to the implied contractual duty of good faith and fair dealing.

Norton v. K-Sea Transportation Partners L.P.,¹²³² involved another limited partnership in which the LPA replaced common law fiduciary duties with a contractual process for approving related party transactions. The plaintiffs alleged that the general partner obtained excessive consideration for its incentive distribution rights (“IDRs”) when an unaffiliated third party purchased the limited partnership. The Supreme Court held that the general partner needed only to exercise its discretion in good faith, as the parties intended that term to be construed, to satisfy its duties under the LPA. Noting that the general partner obtained an appropriate fairness opinion, which under the LPA created a conclusive presumption that the general partner made its decision in good faith, the Supreme Court affirmed the Chancery Court's dismissal of the complaint. In rejecting plaintiff's argument that the general partner is not entitled to a conclusive presumption of good faith because the fairness opinion did not specifically address the IDR payment's fairness, the Supreme Court wrote that the LPA does not require the general partner to evaluate the IDR payment's reasonableness separately from the remaining consideration, and explicitly states that nothing in the LPA shall be construed to require the general partner to consider the interests of any person other than the limited partnership. The general partner was not required to consider whether the IDR payment was fair, but only whether the merger as a whole was in the best interests of the limited partnership (which included the general partner and the limited partnership). Because of those clear provisions, the Supreme Court held that plaintiff had no reasonable contractual expectation that the general partner or the Conflict Committee's investment banker would specifically consider the IDR payment's fairness. Because the fairness opinion satisfied the LPA's requirements, the Court held that the general partner was conclusively presumed to have acted in good faith when it approved the merger and submitted it to the unitholders for a vote, commenting that plaintiff willingly invested in a limited partnership that provided fewer protections to limited partners than those provided under corporate fiduciary duty principles and is bound by his investment decision.

Earlier in *Brinckerhoff v. Enbridge Energy Company, Inc.*,¹²³³ the Supreme Court affirmed the dismissal of derivative claims brought by an LP challenging the fairness of a joint venture (“JV”) entered into between the limited partnership and the controller. The plaintiff alleged that the controller purchased its stake in the JV from the limited partnership for substantially less than its fair value. In affirming the dismissal of plaintiff's complaint, the Supreme Court commented that, in order for the plaintiff to succeed, the decision to enter into the JV must have been so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith. Subsequently the Supreme Court followed

¹²³² 67 A.3d 354 (Del. May 28, 2013).

¹²³³ 67 A.3d 369 (Del. May 28, 2013).

Brinkerhoff in DV Realty Advisors LLC v. Policemen’s Annuity and Benefit Fund of Chicago,¹²³⁴ and held that the removal of a general partner met the contractual subjective good faith standard in the partnership agreement because the action was not “so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith.”

In the foregoing four cases, claims based on implied covenant of good faith and fair dealing were not pursued by the plaintiffs, but in *Gerber v. Enter. Prods. Hldgs., LLC*,¹²³⁵ breach of the implied covenant of good faith and fair dealing was pled and was outcome determinative in the Supreme Court. *Gerber* involved allegations by a limited partnership that the limited partnership’s purchase of interests in an entity controlled by its controller was unfair to the limited partnership, in violation of its LPA and in breach of the duty of good faith owed to the limited partners. Its LPA substituted a subjective good faith standard and Conflicts Committee process for common law fiduciary duties. The challenged transaction was, in fact, approved by the Conflicts Committee as in the Committee’s subjective belief in the best interest of the limited partnership. The plaintiff pleaded a claim for breach of the implied contractual covenant of good faith and fair dealing, alleging that the fairness opinion relied upon by the Conflicts Committee did not value separately the consideration the limited partnership actually received and did not address the value of the limited partnership’s claims against the general partner, the elimination of which was a disclosed purpose of the transaction. The Supreme Court explained its holding on the basis of the implied contractual covenant of good faith and fair dealing in temporal conceptual terms. Adopting the reasoning in *ASB Allegiance Real Estate Fund v. Scion Breckenridge Managing Member, LLC*,¹²³⁶ the Supreme Court explained the implied covenant seeks to enforce the parties’ contractual bargain by implying only those terms that the parties would have agreed to during their original negotiations if they had thought to address them and “a court confronting an implied covenant claim asks whether it is clear from what was expressly agreed upon that the parties who negotiated the express terms of the contract would have agreed to proscribe the act later complained of as a breach of the implied covenant of good faith—had they thought to negotiate with respect to that matter.” In contrast under a common law fiduciary duty or tort analysis, a court examines the parties as situated at the time of the wrong, determining whether the defendant owed the plaintiff a duty which was breached.

Focusing on the alleged unfairness of the challenged transaction in which the limited partnership sold the interests to the controller for only 9% of limited partnership’s original purchase price and that the fairness opinion did *not* address whether holders of the limited partnership units received fair consideration for the limited partnership’s interest (it only addressed the total consideration paid to all parties in two related transactions), the Court held that when plaintiff agreed in the LPA to be bound by the LPA’s conclusive presumption the general’s contractual fiduciary duty to be satisfied if the general partner relied upon the opinion of a qualified expert, plaintiff could hardly have anticipated that the general partner would rely upon a fairness opinion that did not fulfill its basic function—evaluating the consideration the limited partnership unitholders received for purposes of opining whether the transaction was

¹²³⁴ No. 547, 2012, 2013 WL 4517001 (Del. August 26, 2013).

¹²³⁵ 67 A.3d 400 (Del. June 10, 2013).

¹²³⁶ 50 A.3d 434, 440-42 (Del. Ch. 2012), *aff’d in part, rev’d in part on other grounds* by Scion Breckenridge Managing Member LLC v. ASB Allegiance Real Estate, 68 A.3d 665 (Del. May 9, 2013).

financially fair. It held this is the type of arbitrary, unreasonable conduct that the implied covenant prohibits.

Applying a similar analysis, the Court concluded “that the parties would certainly have agreed, at the time of contracting, that any fairness opinion contemplated by that provision would address the value of derivative claims where (as here) terminating those claims was a principal purpose of a merger.” In addition to clarifying that an LPA definition of good faith cannot restrict the implied contractual covenant of good faith and fair dealing, *Gerber* teaches that fairness opinions in M&A transactions involving Delaware alternative entities should (i) address the fairness of the consideration to be received by the limited partners (separately from the general partner) in each transaction on which it will be relied to satisfy the implied contractual covenant of good faith and fair dealing requirements under Delaware law and (ii) take into account the value of derivative claims being eliminated by a merger to which it relates.

The foregoing cases illustrate that Delaware courts will generally respect the DRLPA statutory authority to eliminate common law fiduciary duties in an LPA if the LPA clearly does so.¹²³⁷ The *Gerber* case notwithstanding, where they have found that parties have expressly limited fiduciary duties in LPAs, Delaware courts have been reluctant to use the implied covenant of good faith and fair dealing, viewing this concept instead as more of a gap-filler where the parties had not contemplated the particular circumstance. After *Gerber*, however, it is likely that claims based on the implied covenant will be pursued more vigorously.

Further, where fiduciary duties have been eliminated by a partnership agreement provision and replaced by a contractual process for approving conflict of interest transactions, the general partner may be held liable if the process was not followed. In *In re El Paso Pipeline Partners, L.P. Derivative Litigation*,¹²³⁸ the partnership agreement eliminated default fiduciary duties and replaced them with a contractual standard requiring that the persons approving an action on behalf of the partnership subjectively believe that the action is in the best interests of the partnership. In *El Paso*, the conflicts committee responsible for approving the dropdown transaction was composed solely of independent directors, had engaged its own legal and financial advisors, had received from its financial advisor an opinion that the challenged transaction was fair from a financial point of view to the unaffiliated unitholders of the partnership, and ultimately approved the transaction. The Court ruled that under *El Paso* MLP’s partnership agreement each conflicts committee member had an affirmative duty to conclude that the challenged transaction was in the best interests of the partnership, but that the conflicts committee members did not actually conclude that the challenged transaction was in the best interests of the partnership. The Court found that the conflicts committee had focused extensively on the expected accretion from the challenged transaction—*i.e.*, the amount by which the cash distributions for common unitholders of the partnership would be expected to increase—but failed to take sufficiently into account the valuation of the assets being acquired under traditional valuation analyses. Although the committee members and their financial adviser testified that they in good faith believed that the transaction was in the best interests of

¹²³⁷ *Norton v. K-Sea Trans. Partners L.P.*, 67 A.3d 354 (Del. 2013); see *Miller v. Am. Real Estate Partners, L.P.*, C.A. No. 16788, 2001 WL 1045643, at *8 (Del. Ch. Sept. 6, 2001) (“A topic as important as [limitation or elimination of common law fiduciary duties] should not be addressed coyly.”).

¹²³⁸ C.A. No. 7141-VCL (Del. Ch. Apr. 20, 2015).

the partnership, the Court found that their testimony was not credible in the face of objective evidence that the committee and its financial adviser did not have adequate information to justify the partnership paying more for the assets than the assets were objectively worth and that they were merely going through the motions in approving a transaction which they knew the general partner wanted (and who they wanted to accommodate) and about which emails and other evidence showed they had reservations. The Court awarded damages against the general partner of \$171 million, which the Court determined to be the difference between what the partnership actually paid for the assets acquired in the challenged transaction and the fair value of the assets.

A corporation that controls the general partner may owe a duty of loyalty to the limited partnership.¹²³⁹ Directors of a corporate general partner who dominate and control the underlying limited partnership can be liable for the corporate general partner's breach of fiduciary duty to the limited partners.¹²⁴⁰ Similarly, the parent and grandparent entities of the managing owner of a Delaware statutory business trust may be liable, directly or indirectly, for exercising control over or aiding and abetting the managing owner's actions to serve its own self-interest in violation of its fiduciary duties to the Delaware statutory business trust, which suffered significant losses as a result of a transfer of certain of its assets to a third party shortly before the transferee's collapse.¹²⁴¹

4.7. Business Combinations. Under Texas law, a limited partnership may merge with a corporation, LLC or another partnership and convert from a limited partnership into another form of entity without effecting a merger or transfer of assets.¹²⁴² The Tex. LP Stats. have provisions relating to the mechanics of adopting a plan of merger or conversion, obtaining owner approval, filing with the Secretary of State, and protecting creditors.

The Tex. LP Stats. do not contain any analogue to TBCA articles 5.09 and 5.10 and the parallel TBOC provisions which require shareholder approval of sales of all or substantially all

¹²³⁹ *James River-Pennington, Inc. v. CRSS Capital, Inc.*, C.A. No. 13870, 1995 WL 106554, at *11 (Del. Ch. Mar. 6, 1995) (also recognizing also that the general partner's fiduciary duties might be modified by the limited partnership agreement); *Bigelow/Diversified Secondary P'ship Fund 1990 v. Damson/Birtcher Partners*, C.A. No. 16630-NC, 2001 WL 1641239, at *1-2, 8-9 (Del. Ch. Dec. 4, 2001) (holding that various "upstream" entities controlling general partners could owe fiduciary duties to either the partnership or the limited partners, the Court explained: "While mere ownership—either direct or indirect—of the general partner does not result in the establishment of a fiduciary relationship, those 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.").

¹²⁴⁰ *In re USACafes, L.P. Litig.*, 600 A.2d 43, 48 (Del. Ch. 1991); see also *Bigelow/Diversified Secondary Partnership Fund 1990 v. Damson/Birtcher Partners*, C.A. No. 16630-NC, 2001 WL 1641239 (Del. Ch. Dec. 4, 2001).

¹²⁴¹ *Cargill, Inc. v. JWH Special Circumstance LLC*, 959 A.2d 1096 (Del. Ch. 2008).

¹²⁴² TRLPA §§ 2.11, 2.15; TBOC §10.001. In order for a limited partnership to participate in a conversion, consolidation, or merger, the partnership agreement *must* authorize such action and the process for its approval. See TRLPA §§ 2.11(a)(1), 2.11(a)(2), 2.11(d)(1)(F), 2.15(a)(1); TBOC § 10.009(f). Therefore, it is important to include such a provision. Failure to include the provision will mean that, if such a transaction is desired, the partnership agreement will first need to be amended to permit it. To the extent the merger also results in amendments to the partnership agreement, the provisions relating to amendments will also need to be followed, so it would be prudent to coordinate the vote needed for conversions, consolidations, and mergers with the vote needed for amendments.

of a corporation's assets in certain circumstances.¹²⁴³ Requirements for limited partner approval of an asset transaction are left to the limited partnership agreement if the partners wish to provide such requirements.

4.8. Indemnification. A limited partnership is required to indemnify a general partner who is “wholly successful on the merits or otherwise” unless indemnification is limited or prohibited by a written partnership agreement.¹²⁴⁴ A limited partnership is prohibited from indemnifying a general partner who is found liable to the limited partners or the partnership or for an improper personal benefit if the liability arose out of willful or intentional misconduct.¹²⁴⁵ A limited partnership is permitted, if provided in a written partnership agreement, to indemnify a general partner who is determined to meet certain standards. These standards require that the general partner conducted himself in good faith, reasonably believed the conduct was in the best interest of the partnership (if the conduct was in an official capacity) or that the conduct was not opposed to the partnership's best interest (in cases of conduct outside the general partner's official capacity), and, in the case of a criminal proceeding, had no reasonable cause to believe the conduct was unlawful.¹²⁴⁶ If a general partner is not liable for willful or intentional misconduct, but is found liable to the limited partners or partnership for improper benefit, permissible indemnification is limited to reasonable expenses.¹²⁴⁷ General partners may only be indemnified to the extent consistent with the statute.¹²⁴⁸ Limited partners, employees and agents who are not also general partners may be indemnified to the same extent as general partners and to such further extent, consistent with law, as may be provided by the partnership agreement, general or specific action of the general partner, by contract, or as permitted or required by common law.¹²⁴⁹ Insurance providing coverage for unindemnifiable areas is expressly permitted.¹²⁵⁰

4.9. Flexibility In Raising Capital. Limitations on liability and more centralized management make the limited partnership a more suitable entity for raising capital than the general partnership. However, the limited partnership's usefulness with respect to raising capital is limited by restrictions on the ability of owners to deduct passive losses for federal income tax purposes.

Under Tex. LP Stats., contributions to a limited partnership by either a general or a limited partner may consist of any tangible or intangible benefit to the limited partnership or other property of any kind or nature, including cash, a promissory note, services performed, a contract for services to be performed, other interests in or securities of the limited partnership, or interests or securities of any other limited partnership, domestic or foreign, or other entity.¹²⁵¹ However, a conditional contribution obligation, including a contribution payable upon a

¹²⁴³ See *supra* notes 88-89 and related text regarding the requirements of TBCA arts. 5.09 and 5.10 and the parallel TBOC provisions.

¹²⁴⁴ TRLPA §§ 11.08, 11.21; TBOC §§ 8.003, 8.051.

¹²⁴⁵ TRLPA §§ 11.03, 11.05; TBOC § 8.102(b).

¹²⁴⁶ TRLPA § 11.02; TBOC § 8.101(a).

¹²⁴⁷ TRLPA §§ 11.03, 11.05; TBOC § 8.102(b).

¹²⁴⁸ TRLPA § 11.13; TBOC § 8.004.

¹²⁴⁹ TRLPA §§ 11.15, 11.17; TBOC § 8.105.

¹²⁵⁰ TRLPA § 11.18; TBOC § 8.151.

¹²⁵¹ TRLPA § 5.01; TBOC § 153.201.

discretionary call prior to the time the call occurs, may not be enforced until all conditions have been satisfied or waived.¹²⁵²

A general partner in a Texas limited partnership does not need to have an economic ownership interest in the limited partnership. A general partner does not have to make any capital contribution, share in profits or losses or have a capital account in the limited partnership. Although a general partner is personally liable for all of the debts and obligations of the limited partnership¹²⁵³ and if provided in a written partnership agreement, (i) a person may be admitted as a general partner in a limited partnership, including as the sole general partner, and acquire a partnership interest in the limited partnership without (x) making a contribution to the limited partnership or (y) assuming an obligation to make a contribution to the limited partnership; and (ii) a person may be admitted as a general partner in a limited partnership, including as the sole general partner, without acquiring a partnership interest in the limited partnership.¹²⁵⁴

Absent a contrary provision in the written partnership agreement, profits and losses of a limited partnership are to be allocated in accordance with the partnership interests reflected in the records that the partnership is required to maintain under Tex. LP Stats., or in the absence of such records, in proportion to capital accounts.¹²⁵⁵ Additionally, absent a different provision in the written partnership agreement, distributions representing a return of capital are to be made in accordance with the relative agreed value of capital contributions made by each partner, and other distributions are made in proportion to the allocation of profits.¹²⁵⁶

4.10. Transferability of Ownership Interests. Unless otherwise provided by the limited partnership agreement, a partnership interest is assignable in whole or in part and will not require winding up a limited partnership.¹²⁵⁷ The assignment of the partnership interest will not, however, entitle the assignee to become, or to exercise the rights or powers of, a partner unless the partnership agreement provides otherwise.¹²⁵⁸ Instead, the assignment will entitle the assignee to an allocation of income, gain, loss, deductions, credits or similar items and to receive distributions to which the assignor was entitled.¹²⁵⁹ If a general partner assigns all of his or her rights as a general partner, a majority in interest of the limited partners may terminate the assigning general partner's status as a general partner.¹²⁶⁰ Until an assignee of a partnership interest becomes a partner, the assignee has no liability as a partner solely by reason of the assignment.¹²⁶¹

¹²⁵² TRLPA § 5.02(d); TBOC § 153.202.

¹²⁵³ TRLPA §§ 4.01(d), 4.03(b); TBOC § 153.152.

¹²⁵⁴ TRLPA § 4.01(c); TBOC § 153.151(c), (d).

¹²⁵⁵ See TRLPA § 5.03; TBOC § 153.206.

¹²⁵⁶ See TRLPA § 5.04; TBOC § 153.208.

¹²⁵⁷ TRLPA § 7.02; TBOC § 153.251.

¹²⁵⁸ TRLPA § 7.02(a)(2); TBOC § 153.251(b)(2).

¹²⁵⁹ TRLPA § 7.02(a)(3); TBOC § 153.251(b)(3).

¹²⁶⁰ TRLPA § 7.02(a)(4); TBOC § 153.252(b).

¹²⁶¹ TRLPA § 7.02(b); TBOC § 153.254(a).

Limited partnership interests are generally considered “securities” within the meaning of federal and state securities laws. Transfers of limited partnership interests are generally required to be registered under such laws absent an application exemption from such registration.¹²⁶²

4.11. Continuity of Life. Although a limited partnership does not have an unlimited life to the same extent as a corporation, the death or withdrawal of a limited partner or the assignment of the limited partner interest to a third party will not affect the continuity of existence of the limited partnership unless the partners agree otherwise or unless no limited partners remain.¹²⁶³ A limited partnership was dissolved under TRLPA, or is required to commence winding up under the TBOC, upon the first to occur of the following events: (i) any event specified in the partnership agreement as causing dissolution, or the winding up or termination of, the partnership, (ii) all of the partners of the limited partnership agreeing in writing to dissolve the limited partnership, (iii) an event of withdrawal of a general partner under the Tex. LP Stats. (i.e., death, removal, voluntary withdrawal and, unless otherwise provided in the partnership agreement, bankruptcy of a general partner)¹²⁶⁴ absent certain circumstances¹²⁶⁵ or (iv) a court of competent jurisdiction dissolving the partnership because (a) the economic purpose of the partnership is likely to be unreasonably frustrated, (b) a partner has engaged in conduct relating to the partnership that makes it not reasonably practicable to carry on the business in the partnership with that partner, or (c) it is not reasonably practicable to carry on the business of the limited partnership in conformity with the partnership agreement.¹²⁶⁶

If the limited partnership is terminated or dissolved, the limited partnership’s affairs must be wound up as soon as reasonably practicable unless it is reconstituted or the partnership agreement provides otherwise.¹²⁶⁷ However, upon the withdrawal of a general partner (unless the limited partnership agreement otherwise provides),¹²⁶⁸ the limited partnership may continue its business without being wound up if (i) at least one general partner remains and the partnership agreement permits the business of the limited partnership to be carried on by the remaining general partner or partners or (ii) all (or a lesser percentage stated in the partnership agreement) remaining partners agree in writing to continue the business of the limited partnership within a

¹²⁶² See *infra* notes 1399-1402 and related text.

¹²⁶³ TRLPA §§ 8.01, 8.02; TBOC §§ 11.051, 11.058.

¹²⁶⁴ TRLPA § 4.02; TBOC § 153.155.

¹²⁶⁵ Under TRLPA § 6.02 and TBOC § 153.155(b), a general partner has a right to withdraw which cannot be eliminated by the partnership agreement, although the partnership may prohibit withdrawal and violation thereof can result in the general partner being liable for damages. TRLPA § 6.03 and TBOC § 153.110 provide that a limited partner may withdraw in accordance with the partnership agreement; previously a limited partner could withdraw on six months notice if the partnership agreement were silent on limited partner withdrawal. Under TBOC § 11.058(b), as amended in 2007 by 2007 H.B. 1737, a winding up of a limited partnership is not required by the TBOC if the limited partnership agreement provides that withdrawal of the general partner does not require winding up of the limited partnership.

¹²⁶⁶ TRLPA § 8.02; TBOC §§ 11.051, 11.314.

¹²⁶⁷ TRLPA § 8.04; TBOC § 11.052.

¹²⁶⁸ TRLPA § 8.01(3); TBOC §§ 11.051(4), 11.058(b).

specified period after the occurrence of the dissolution event and agree to the appointment, if necessary, of one or more new general partners.¹²⁶⁹

Many existing limited partnership agreements contain provisions defining events of withdrawal in a manner intended to negate continuity of life for purposes of the Former Classification Regulations (e.g., certain events of bankruptcy of the general partner). Since these dissolution provisions are not required under the current Check-the-Box Regulations, consideration should be given to whether the provisions conform to the business purposes of the partners; if they do not, the provisions should be amended. The lenders to these limited partnerships, as well as the lenders' lawyers, may also have an interest in the wording of the limited partnership dissolution provisions.

4.12. Operations in Other Jurisdictions. Multistate operations of limited partnerships have been prevalent for a sufficient period for most states to have limited partnership statutes which contain provisions for the qualification of foreign limited partnerships to do business as such so that the limited liability of the limited partners will be recognized under local law.¹²⁷⁰ To qualify to do business as a foreign limited partnership in most states, the limited partnership must file with the state's secretary of state evidence of its existence and an application that generally includes *inter alia* information regarding its jurisdiction and state of organization, its registered office and agent for service of process in the state (and providing that in the event that there is at any relevant time no duly designated agent for service of process in the state, then appointing the state's secretary of state as agent for service of process), the names and addresses of its general partners, the business it proposes to pursue in the state and the address of its principal office.

In New York there is now an additional requirement that within 120 days after the filing of its application for authority, the foreign limited partnership must publish once each week for six successive weeks in one daily and one weekly newspaper (each being designated by the county clerk in the county where the partnership is located) generally the same information required to be filed with the New York Department of State and must file a proof of publication with the New York Department of State. Failure to file such proof of publication will result in automatic suspension of the entity's right to transact business in New York.¹²⁷¹

CHAPTER 5. LIMITED LIABILITY COMPANY.

5.1. General. LLCs formed under Texas law are now governed by Title 3 and pertinent provisions of Title 1 of the TBOC.¹²⁷² Because until January 1, 2010 some LLCs were governed

¹²⁶⁹ TRLPA § 8.01; TBOC §§ 11.051(4), 11.058(2), 11.152(a), 153.501(b). Under the TRLPA, such agreement must be made within ninety days; under the TBOC, it must be made within a year. TBOC § 153.501 and Revisor's Note thereto. The partnership agreement may also provide for continuation of the partnership after dissolution for reasons in addition to an event of withdrawal in respect of a general partner.

¹²⁷⁰ See TRLPA article 9; see generally TBOC title 1, chapter 9.

¹²⁷¹ N.Y. REV. LTD. P'SHP ACT § 121-902 (McKinney Supp. 2006). N.Y. REV. LTD. P'SHP ACT § 121-201 (McKinney Supp. 2006) contains similar publication requirements for newly formed domestic limited partnerships.

¹²⁷² TBOC §§ 401.001, 402.003. The TBOC provisions applicable to LLCs may be officially and collectively referred to as "Texas Limited Liability Company Law." TBOC § 1.008(e).

by the LLC Act¹²⁷³ and others by the TBOC and because the substantive principles under both statutes are generally the same, the term “Tex. LLC Stats.” is used herein to refer to the TBOC and the LLC Act collectively, and the particular differences between the LLC Act and the TBOC are referenced as appropriate. Texas was the fourth state to adopt an LLC statute and now every state has adopted an LLC statute.¹²⁷⁴

“The allure of the [LLC] is its unique ability to bring together in a single business organization the best features of all other business forms - properly structured, its owners obtain both a corporate-styled liability shield and the pass-through tax benefits of a partnership.”¹²⁷⁵ All equity holders of an LLC have the limited liability of corporate shareholders even if they participate in the business of the LLC. Thus the Tex. LLC Stats. contemplate that LLCs will be organized with features that resemble corresponding features of corporations.

The owners of an LLC are called “Members,”¹²⁷⁶ and are analogous to shareholders in a corporation or limited partners of a limited partnership.¹²⁷⁷ The “Managers” of an LLC are generally analogous to directors of a corporation and are elected by the Members in the same manner as corporate directors are elected by shareholders.¹²⁷⁸ Under the Tex. LLC Stats., however, an LLC may be structured so that management shall be by the Members as in the case of a close corporation or a general partnership,¹²⁷⁹ and in that case the Members would be analogous to general partners in a general or limited partnership but without personal liability for the LLC’s obligations.¹²⁸⁰ Under the Tex. LLC Stats., any “person” may become a Member or Manager.¹²⁸¹ Because of the broad definition given to “person” by the Tex. LLC Stats., any individual, corporation, partnership, LLC or other person may become a Member or Manager.¹²⁸²

¹²⁷³ The Texas Limited Liability Company Act, as amended, is found at TEX. REV. CIV. STAT. ANN. art. 1528n (Vernon Supp. 2011) (hereinafter “LLC Act”). The operational provisions of the LLC Act are modeled after the TBCA, the TMCLA, and TRLPA. *Summary of Business Organizations Bill (HB 278)*, 28 BULL. OF BUS. L. SEC. OF THE ST. B. OF TEX. 2, 31-41 (June 1991) [hereinafter “*1991 Bill Analysis Summary*”]; TEX. REV. CIV. STAT. ANN. art. 1302 (Vernon Supp. 2011); TEX. REV. CIV. STAT. ANN. art. 1302 (Vernon 2003 & Supp. 2004); TEX. REV. CIV. STAT. ANN. art. 6132a-1, arts. 1-13 (Vernon Supp. 2011).

¹²⁷⁴ See Charles W. Murdock, *Limited Liability Companies in the Decade of the 1990s: Legislative and Case Law Developments and Their Implications for the Future*, 56 BUS. LAW 499, 502 (2001).

¹²⁷⁵ *PB Real Estate, Inc. v. DEM Properties II*, 719 A.2d 73, 74 (Conn. App., 1998); see Rodney D. Chrisman, *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*, XV FORDHAM J. CORP. & FIN. L. 459 (2010)

¹²⁷⁶ LLC Act § 4.01; TBOC §§ 1.002(53), 101.101, 101.102.

¹²⁷⁷ 1991 Bill Analysis Summary at 41.

¹²⁷⁸ See LLC Act § 2.13; TBOC § 101.302; 1991 Bill Analysis Summary at 41.

¹²⁷⁹ LLC Act § 2.12; TBOC §§ 1.002(35), 101.251.

¹²⁸⁰ 1991 Bill Analysis Summary at 41.

¹²⁸¹ LLC Act § 4.01C; TBOC § 101.102(a).

¹²⁸² “Person” is defined in TBOC § 1.002(69-b) as follows:

(69-b) “Person” means an individual or a corporation, partnership, limited liability company, business trust, trust, association, or other organization, estate, government or governmental subdivision or agency, or other legal entity.

“Person” was similarly defined in LLC Act § 1.02(4).

Thus, it is possible to have an LLC with a corporation as the sole Manager just as it is possible to have a limited partnership with a sole corporate general partner.

Under the Check-the-Box Regulations, a domestic LLC with two or more Members typically would be treated for federal income tax purposes as a partnership.¹²⁸³ An LLC is subject to Texas Margin Tax.¹²⁸⁴

An underlying premise of the Tex. LLC Stats. is that the LLC is based in large part upon a contract between its Members, similar to a partnership agreement. As a result, fundamental principles of freedom of contract imply that the owners of an LLC have maximum freedom to determine the internal structure and operation of the LLC. Thus the Tex. LLC Stats. would be classified as “flexible” LLC statutes.¹²⁸⁵ This freedom of contract, however, could have resulted in the inadvertent loss of partnership classification for federal income tax purposes under the Former Classification Regulations.¹²⁸⁶

The Tex. LLC Stats. in many cases provide “default” provisions¹²⁸⁷ designed to reflect the common expectations of persons engaged in business under the Former Classification Regulations, and to permit those expectations to be met in the event that the LLC’s organizational documents do not include a provision specifically dealing with an issue. These default provisions, however, may result in restrictions on the LLC that are not necessary under the Check-the-Box Regulations and may unnecessarily change the intended business deal.¹²⁸⁸ Examples of provisions that were often included in an LLC structure because of the Former Classification Regulations, and which are not required by either the Tex. LLC Stats. or the Check-the-Box Regulations, include:

- (i) limited duration (the TBOC now permits an LLC to have a perpetual duration like a corporation);
- (ii) management by Members rather than Managers;
- (iii) restrictions on assignments of interests beyond what is required by applicable securities laws and the desires of the parties; and
- (iv) dissolution of the LLC upon the death, expulsion, withdrawal, bankruptcy or dissolution of a Member.

¹²⁸³ See Appendix A – Federal Taxation of Entities.

¹²⁸⁴ See Appendix B –Texas Margin Tax. The LLC is not subject to a franchise tax in Delaware or most other states. See Bruce P. Ely & Christopher R. Grissom, *State Taxation of LLCs and LLPs: An Update*, 1 BUS. ENTITIES 24 (Mar./Apr. 1999).

¹²⁸⁵ See Robert B. Keatinge, *New Gang in Town - Limited Liability Companies: An Introduction*, 4 BUS. L. TODAY 5 (Mar./Apr. 1995).

¹²⁸⁶ See Robert F. Gray *et al.*, *Corporations*, 45 Sw.L.J. 1525, 1537 (1992).

¹²⁸⁷ See HOUSE COMM. ON BUS. & INDUS., BILL ANALYSIS, Tex. H.B. 1239, 73d Leg., R.S. (1993) at 1 [hereinafter 1993 LLC Bill Analysis].

¹²⁸⁸ See William D. Bagley, *The IRS Steps Back - Entity Classification Rules are Relaxed*, 6 BUS. L. TODAY 41 (1997).

5.2. Formation and Governing Documents.

5.2.1. Certificate of Formation. An LLC is formed when one or more persons file a certificate of formation with the Texas Secretary of State along with a \$300 filing fee.¹²⁸⁹ The initial certificate of formation must contain: (1) the name of the LLC, (2) a statement that it is an LLC, (3) the period of its duration, unless such duration is perpetual, (4) its purpose, which may be any lawful purpose for which LLCs may be organized, (5) the address of its initial registered office and the name of its initial registered agent at that address, (6) if the LLC is to have a Manager or Managers, a statement to that effect and the names and addresses of the initial Manager or Managers, or if the LLC will not have Managers, a statement to that effect and the names and addresses of the initial Members, (7) the name and address of each organizer, (8) specified information if the LLC is to be a professional LLC, and (9) any other provisions not inconsistent with law.¹²⁹⁰ An LLC's existence as such begins when the Secretary of State files the certificate of formation, unless it provides for delayed effectiveness as authorized by the TBOC.¹²⁹¹ An LLC may also be formed pursuant to a plan of conversion or merger, in which case the certificate of formation must be filed with the certificate of conversion or merger, but need not be filed separately. In such case the LLC's formation takes effect on the effectiveness of the plan.¹²⁹²

Under Texas law, an LLC may generally be formed to conduct any lawful business, subject to limitations of other statutes which regulate particular businesses.¹²⁹³ It has all of the powers of a Texas corporation or limited partnership, subject to any restrictions imposed by statute or its governing documents.¹²⁹⁴

The name of an LLC must contain words or an abbreviation to designate the nature of the entity. The designation may be any of the following: the words "limited liability company,"

¹²⁸⁹ TBOC §§ 3.001, 4.152(1), 4.154. Prior to January 1, 2006, an LLC was formed by filing articles of organization with the Secretary of State, which were similar to a certificate of limited partnership under TRLPA and articles of incorporation under the TBCA. *See* LLC Act §§ 3.01, 9.01.

¹²⁹⁰ TBOC §§ 3.005, 3.010, 3.014.

¹²⁹¹ TBOC §§ 4.051, 4.052.

¹²⁹² TBOC § 3.006(b).

¹²⁹³ LLC Act § 2.01 provides as follows:

Art. 2.01. PURPOSES. A. A limited liability company formed under this Act may engage in any lawful business unless a more limited purpose is stated in its articles of organization or regulations.

B. A limited liability company engaging in a business that is subject to regulation by another Texas statute may be formed under this Act only if it is not prohibited by the other statute. The limited liability company is subject to all limitations of the other statute.

LLC Act § 2.01 provides that a limited liability company "may engage in any lawful business." The term "business," as defined in LLC Act § 1.02.A(6), means every "trade and occupation or profession." Based on the foregoing, a limited liability company governed by the LLC Act possibly could not be used for a nonprofit purpose. However, under the TBOC, an LLC's purpose "may be stated to be or include any lawful purpose for [an LLC]." TBOC § 3.005(3). Such broad language would seem to negate the prior profit versus nonprofit ambiguity. *See also* TBOC § 2.001 (providing "A domestic entity has any lawful purpose or purposes, unless otherwise provided by this code.").

¹²⁹⁴ Governing documents, as used here, includes an LLC's Articles of Organization, Certificate of Formation, Regulations, or Company Agreement. LLC Act § 2.02; *see* TBOC § 101.402.

“limited company,” or an abbreviation of either phrase.¹²⁹⁵ The name must not be the same as or deceptively similar to that of any domestic or foreign filing entity authorized to transact business in Texas.¹²⁹⁶ Prior to accepting a certificate of formation for filing, the Secretary of State reviews its LLC, limited partnership and corporation records to determine whether the LLC’s proposed name is impermissibly close to that of an existing filing entity.¹²⁹⁷

The Tex. LLC Stats. provide that, except as otherwise provided in an LLC’s certificate of formation or Company Agreement, the affirmative vote, approval, or consent of all Members is required to amend its certificate of formation.¹²⁹⁸ Any such amendment must include a statement that it was approved in accordance with the proper provisions of governing laws,¹²⁹⁹ or for entities governed by the LLC Act, alternately as provided in the articles of organization or Regulations, along with the date of approval.¹³⁰⁰

LLC Act section 2.23G provided that if the LLC has not received any capital and has not otherwise commenced business, the articles of organization may be amended by and the LLC may be dissolved by (a) a majority of the Managers, if there are no Members, or (b) a majority of the Members, if there are no Managers. The TBOC does not contain such an express provision, but simply grants broad leeway for an LLC’s Company Agreement (equivalent to the “Regulations” under the LLC Act) to govern such matters.¹³⁰¹

5.2.2. Company Agreement. Most of the provisions relating to the organization and management of an LLC and the terms governing its securities are to be contained in the LLC’s company agreement (“Company Agreement”), which will typically contain provisions similar to those in limited partnership agreements and corporate bylaws.¹³⁰² A Company Agreement is the same as the document referred to as (i) the “Regulations” for LLCs governed by the LLC Act and (ii) a limited liability company agreement for LLCs governed by the Delaware Limited Liability Company Act (the “DLLCA”).¹³⁰³ A Company Agreement may be oral or in writing,¹³⁰⁴ but an oral Company Agreement is subject to the statute of frauds.¹³⁰⁵ The

¹²⁹⁵ TBOC § 5.056. However, LLCs formed prior to September 1, 1993 in compliance with the laws then in existence need not change their names to comply with the current provisions. TBOC § 5.056(b).

¹²⁹⁶ TBOC § 5.053.

¹²⁹⁷ *Id.*

¹²⁹⁸ LLC Act § 2.23H; TBOC §§ 101.356(d), 101.051, 101.052. For LLCs that continue to be governed by the LLC Act, the pertinent documents are referred to as the articles of organization and the Regulations.

¹²⁹⁹ LLC Act § 3.06(3); TBOC § 3.053(4).

¹³⁰⁰ LLC Act § 3.06(3).

¹³⁰¹ *See* TBOC §§ 101.051, 101.052.

¹³⁰² LLC Act § 2.09A; TBOC § 101.052; Joint Task Force of the Committee on LLCs, Partnerships and Unincorporated Entities and the Committee on Taxation, ABA Section of Business Law, *Model Real Estate Development Operating Agreement with Commentary*, 63 BUS. LAW. 385 (February 2008).

¹³⁰³ Del. Code Ann. tit. 6 § 18-101 *et. seq.*

¹³⁰⁴ TBOC § 101.001(1); DLLCA § 18-101(7).

¹³⁰⁵ An oral agreement which is not to be performed within one year from the date of making of the agreement is barred by the statute of frauds. TEX. BUS. & COM. CODE ANN. § 26.01(b)(6) (Vernon Supp. 2011). To be enforceable, an agreement to make contributions of cash or property to an LLC must be in writing and signed by the person making the promise. TBOC § 101.151. Likewise, profits and losses are to be allocated, and distributions made, according to the written agreed value of contributions found in the LLC’s

complexity of the matters typically addressed in a Company Agreement make it rare and inadvisable to have an oral Company Agreement.

Under the TBOC, the Company Agreement controls the majority of LLC governance matters and generally trumps the default TBOC provisions relating to LLCs, but certain provisions of the Tex. LLC Stats. may not be waived or modified by Regulations or Company Agreement.¹³⁰⁶ For example, the TBOC provides that the Company Agreement or certificate of

company records. TBOC §§ 101.501, 101.201, 101.203. *See Olson v. Halvorsen*, 982 A.2d 286 (Del. Ch. 2008), judgment aff'd by 986 A.2d 1150 (Del. 2009) (Delaware statute of frauds, which provides “an agreement ‘that is not to be performed within the space of one year from the making thereof’ must be reduced to writing and signed by the party against which the agreement is to be enforced,” applies to a Delaware LLC agreement; noting that “the statute of frauds does not apply to any contract which may, by any possibility, be performed within a year,” the court observed that few oral LLC agreements would contain terms that could not possibly be performed within one year and thus ordinarily the statute of frauds would not limit the enforcement of oral LLC agreements; nevertheless, in the case before it, the court held that the earnout provision at issue violated the statute of frauds because it could not be performed within a year and none of the exceptions to the statute of frauds was applicable).

¹³⁰⁶ TBOC §§ 101.052 and 101.054 provide as follows:

Sec. 101.052. COMPANY AGREEMENT. (a) Except as provided by Section 101.054, the company agreement of a limited liability company governs:

(1) the relations among members, managers, and officers of the company, assignees of membership interests in the company, and the company itself; and

(2) other internal affairs of the company.

(b) To the extent that the company agreement of a limited liability company does not otherwise provide, this title and the provisions of Title 1 applicable to a limited liability company govern the internal affairs of the company.

(c) Except as provided by Section 101.054, a provision of this title or Title 1 that is applicable to a limited liability company may be waived or modified in the company agreement of a limited liability company.

(d) The company agreement may contain any provisions for the regulation and management of the affairs of the limited liability company not inconsistent with law or the certificate of formation.

Sec. 101.054. WAIVER OR MODIFICATION OF CERTAIN STATUTORY PROVISIONS PROHIBITED; EXCEPTIONS. (a) Except as provided by this section, the following provisions may not be waived or modified in the company agreement of a limited liability company:

(1) this section;

(2) Section 101.101(b) [Members Required], 101.151 [Requirements for Enforceable Promise [to make contribution]], 101.206 [Prohibited Distribution; Duty to Return], 101.501 [Supplemental Records Required for Limited Liability Companies], or 101.502 [Right to Examine Records and Certain Other Information];

(3) Chapter 1 [Definitions and Other General Provisions], if the provision is used to interpret a provision or define a word or phrase contained in a section listed in this subsection;

(4) Chapter 2 [Purposes and Power of Domestic Entity], except that Section 2.104(c)(2) [Power to Make Guaranties], 2.104(c)(3) [Power to Make

formation may only be amended by unanimous member consent,¹³⁰⁷ but if either document provides otherwise (such as for amendment by manager consent), then it may be amended pursuant to its own terms.¹³⁰⁸ The only statutory provisions not subject to contrary agreement are enumerated in TBOC section 101.054.¹³⁰⁹ While the structure and wording of the TBOC relating to these matters differs from the source LLC Act, the requirements for amending a Company Agreement have not substantively changed.¹³¹⁰

Guaranties], or 2.113 [Limitation on Powers] may be waived or modified in the company agreement;

(5) Chapter 3 [Formation and Governance], except that Subchapters C [Governing Persons and Officers] and E [Certificates Representing Ownership Interest] may be waived or modified in the company agreement; or

(6) Chapter 4 [Filings], 5 [Names of Entities; Registered Agents and Registered Offices], 7 [Liability], 10 [Mergers, Interest Exchanges, Conversions, and Sales of Assets], 11 [Winding Up and Termination of Domestic Entity], or 12 [Administrative Powers], other than Section 11.056 [Supplemental Provisions for Limited Liability Company].

(b) A provision listed in Subsection (a) may be waived or modified in the company agreement if the provision that is waived or modified authorizes the limited liability company to waive or modify the provision in the company's governing documents.

(c) A provision listed in Subsection (a) may be modified in the company agreement if the provision that is modified specifies:

(1) the person or group of persons entitled to approve a modification;

or

(2) the vote or other method by which a modification is required to be approved.

(d) A provision in this title or in that part of Title 1 [General Provisions] applicable to a limited liability company that grants a right to a person, other than a member, manager, officer, or assignee of a membership interest in a limited liability company, may be waived or modified in the company agreement of the company only if the person consents to the waiver or modification.

Although TBOC § 101.054 expressly states which provisions *cannot* be modified, its predecessor, the LLC Act, only expressly states which provisions *can* be modified. As the Revisor's Note to TBOC § 101.052 explains:

Because of the reversal of the prior assumption that each provision of the [LLC Act] was mandatory (unless expressly qualified) to the new assumption in Sections 101.052 and 101.054 [of the TBOC] that most provisions of the code governing limited liability companies may be waived or modified, a number of the provisions of Title 3 are now stated in such a way that the new provision appears to be the converse of the corresponding provision under the Texas Limited Liability Company Act.

¹³⁰⁷ TBOC §§ 101.053, 101.356(d).

¹³⁰⁸ See TBOC §§ 101.052, 101.054.

¹³⁰⁹ See *supra* note 1306.

¹³¹⁰ See Revisor's Note to TBOC § 101.052; LLC Act §§ 2.09B, 2.23H. With respect to LLCs that continue to be governed by the LLC Act, the default provision in LLC Act § 2.23D provides that the affirmative vote, approval, or consent of a majority of all the Members is required to approve any merger or interest exchange, dissolution or any act which would make it impossible to carry on the ordinary business of the LLC. The

Although the Company Agreement will ordinarily contain the capital account and other financial and tax provisions found in a typical limited partnership agreement,¹³¹¹ the Tex. LLC Stats. do not require that the Company Agreement ever be approved by the Members or be filed with the Secretary of State or otherwise made a public record. Nevertheless it may be desirable for the Members to approve the Company Agreement and agree to be contractually bound thereby.¹³¹² The Members' express agreement to be contractually bound by the Company Agreement should facilitate enforcement thereof and their treatment as a "partnership agreement" for federal income tax purposes.¹³¹³

Under the TBOC a Member has no right to withdraw or be expelled from the Company unless provision therefor is made in the Company Agreement.¹³¹⁴ The TBOC provides that a Member who validly exercises right to withdraw pursuant to a Company Agreement provision is entitled to receive the fair value (a term not defined in the TBOC) of the Member's interest within a reasonable time thereafter unless the Company Agreement otherwise provides.¹³¹⁵

In some other states, the agreement which is referred to in Texas as the Company Agreement is referred to as "operating agreement" or the "LLC agreement."¹³¹⁶

LLC Act default provisions would require unanimous approval of the Members to amend the Articles (LLC Act § 2.23H), issue additional membership interests (LLC Act § 4.01B-1, as amended by 2003 H.B. 1637 effective September 1, 2003) or take action beyond the stated purposes of the LLC (LLC Act § 2.02B). The general default voting provision is in LLC Act § 2.23C-1, which provides that Members or Managers may take action at a meeting or without a meeting in any manner permitted by the Articles, the Regulations or the LLC Act and that, unless otherwise provided by the Articles or the Regulations, an action is effective if it is taken by (1) an affirmative vote of those persons having not fewer than the minimum number of votes that would be necessary to take the action at a meeting at which all Members or Managers, as the case may be, entitled to vote on the action were present and voted; or (2) consent of each Member of the LLC, which may be established by (a) the Member's failure to object to the action in a timely manner, if the Member has full knowledge of the action, (b) consent to the action in writing signed by the Member, or (c) any other means reasonably evidencing consent. Thus, when drafting the Regulations, it is important to override these provisions if they do not properly reflect the desires of the parties. Also, Paragraph F of LLC Act § 2.23 provides, as the default rule, that a majority is defined to be determined on a per-capita basis and not, for instance, by capital contributions or sharing ratios; since this may or may not be appropriate, it is critical that the Regulations properly set forth the appropriate standard for determining what constitutes a majority.

¹³¹¹ It is critical that the Company Agreement accurately reflect the business deal of the parties. Absent a different provision therein, profits and losses of an LLC are to be allocated, and all distributions, whether a return of capital or otherwise, are to be made in accordance with the relative agreed value of capital contributions made by each member reflected in the records that the LLC is required to maintain under the Tex. LLC Stats. LLC Act §§ 2.22, 5.01-1, 5.03; TBOC §§ 3.151, 101.203, 101.501.

¹³¹² The agreement to be contractually bound could be through signing the Company Agreement directly or indirectly through a subscription agreement or power of attorney.

¹³¹³ Philip M. Kinkaid, *Drafting Limited Liability Company Regulations and Articles: Sample Documents*, Address at The University of Texas School of Law Sponsored Conference on Current Issues in Partnerships, Limited Liability Companies, and Registered Limited Liability Partnerships (Jan. 23-24, 1992).

¹³¹⁴ TBOC § 101.107.

¹³¹⁵ TBOC § 101.205.

¹³¹⁶ See, e.g., OHIO REV. CODE ANN. § 1705.01(J) (West 2003) ("operating agreement"); DEL. CODE ANN. tit. 6, § 18-101(7) (2013) ("limited liability company agreement").

5.3. Management. The business and affairs of an LLC with Managers are managed under the direction of its Managers, who can function as a board of directors and may designate officers and other agents to act on behalf of the LLC.¹³¹⁷ A Manager may be an individual, corporation, or other entity, and it is possible to have an LLC which has a single Manager that is a corporation or other entity.¹³¹⁸ The certification of formation or the Company Agreement, however, may provide that the management of the business and affairs of the LLC may be reserved to its Members.¹³¹⁹ Thus an LLC could be organized to be run without Managers, as in the case of a close corporation, or it could be structured so that the day to day operations are run by Managers but Member approval is required for significant actions as in the case of many joint ventures and closely held corporations.

The Company Agreement should specify who has the authority to obligate the LLC contractually or to empower others to do so. It should dictate the way in which the Managers or Members, whichever is authorized to manage the LLC, are to manage the LLC's business and affairs.¹³²⁰ The Tex. LLC Stats. provide that the following are agents of an LLC: (1) any officer or other agent who is vested with actual or apparent authority; (2) each Manager (to the extent that management of the LLC is vested in that Manager); and (3) each Member (to the extent that management of the LLC has been reserved to that Member).¹³²¹ Texas law also provides that an act (including the execution of an instrument in the name of the LLC) for the purpose of apparently carrying on in the usual way the business of the LLC by any of the persons named in LLC Act section 2.21C or TBOC section 101.254(a) binds the LLC unless (1) the person so acting lacks authority to act for the LLC and (2) the third party with whom the LLC is dealing is aware of the actor's lack of authority.¹³²² Lenders and others dealing with an LLC can determine with certainty who has authority to bind the LLC by reference to its certificate of formation, Company Agreement, and resolutions, just as in the case of a corporation. In routine business transactions where verification of authority is not the norm in transactions involving corporations, the same principles of apparent authority should apply in the LLC context.

Members and Managers acting on behalf of an LLC should disclose that they are acting on behalf of the entity and that it is an LLC. Under common law agency principles, an agent can be personally liable on a contract made for an undisclosed or unnamed principal.¹³²³

The Tex. LLC Stats. contain no requirements as to the terms of Managers, but allow the Company Agreement to provide for specified terms of Managers and annual or other regularly scheduled meetings of Members.¹³²⁴ If the Company Agreement is silent as to the terms of

¹³¹⁷ LLC Act §§ 2.12, 2.21; TBOC §§ 101.251-101.253.

¹³¹⁸ LLC Act §§ 2.12, 1.02(4); TBOC § 101.302; TEX. GOV'T CODE § 311.005(2).

¹³¹⁹ LLC Act § 2.12; *see* TBOC § 101.251.

¹³²⁰ TBOC § 101.252. Along the same lines, LLC Act § 2.21B provided that all officers, agents, Managers and Members of an LLC, as among themselves and the LLC, have such authority in the management of the LLC as may be provided in its Regulations or as may be determined by resolution of the Managers or, to the extent to which management is reserved to them, the Members.

¹³²¹ LLC Act § 2.21C; TBOC §§ 1.002(35), (37), 101.254(a).

¹³²² LLC Act § 2.21D; TBOC § 101.254(b).

¹³²³ *See Water, Waste & Land, Inc. v. Lanham*, 955 P.2d 997, 1001 (Colo. 1998).

¹³²⁴ *See* TBOC § 101.303.

Managers, the default provision is retention of the Managers. Tex. LLC Stats. allow any number of classes of Managers, and contains no requirement that such classes either be equal or nearly equal in number or be elected in strict rotation at successive annual meetings of Members.¹³²⁵

5.4. Fiduciary Duties.

5.4.1. Texas. The Tex. LLC Stats. do not address specifically whether Manager or Member fiduciary or other duties exist or attempt to define them,¹³²⁶ but they implicitly recognize that these duties may exist in statutory provisions which permit them to be expanded or restricted, and liabilities for the breach thereof to be limited or eliminated, in the Company Agreement.¹³²⁷

¹³²⁵ See LLC Act § 2.14; TBOC § 101.307.

¹³²⁶ See Elizabeth M. McGeever, *Hazardous Duty? The Role of the Fiduciary in Noncorporate Structures*, 4 BUS. L. TODAY 51, 53 (Mar.–Apr.1995); Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 375, 401 (1992) (noting that LLC statutes usually do not specify fiduciary duties of Members or Managers).

¹³²⁷ LLC Act § 2.20B provides that the Regulations may expand or reduce fiduciary duties as follows:

To the extent that at law or in equity, a member, manager, officer, or other person has duties (including fiduciary duties) and liabilities relating thereto to a limited liability company or to another member or manager, such duties and liabilities may be expanded or restricted by provisions in the regulations.

Similarly, TBOC § 101.401 provides that a Company Agreement may expand or reduce (but not eliminate) fiduciary duties as follows:

The company agreement of a limited liability company may expand or restrict any duties, including fiduciary duties, and related liabilities that a member, manager, officer, or other person has to the company or to a member or manager of the company.

TBOC § 7.001, as amended in 2013 by S.B. 847 § 2, does allow for the limitation or elimination of liabilities for breach of fiduciary duties as follows:

Sec. 7.001. LIMITATION OF LIABILITY OF GOVERNING PERSON.

(a) Subsections (b) and (c) apply to:

- (1) a domestic entity other than a partnership or limited liability company;
- (2) another organization incorporated or organized under another law of this state; and
- (3) to the extent permitted by federal law, a federally chartered bank, savings and loan association, or credit union.

(b) The certificate of formation or similar instrument of an organization to which this section applies may provide that a governing person of the organization is not liable, or is liable only to the extent provided by the certificate of formation or similar instrument, to the organization or its owners or members for monetary damages for an act or omission by the person in the person's capacity as a governing person.

(c) Subsection (b) does not authorize the elimination or limitation of the liability of a governing person to the extent the person is found liable under applicable law for:

- (1) a breach of the person's duty of loyalty, if any, to the organization or its owners or members;
- (2) an act or omission not in good faith that:
 - (A) constitutes a breach of duty of the person to the organization; or
 - (B) involves intentional misconduct or a knowing violation of law;

The duty of Managers in a Manager-managed LLC and Members in a Member-managed LLC to the LLC is generally assumed to be fiduciary in nature, measured by reference to the fiduciary duties of corporate directors in the absence of modification in the Company Agreement. The fiduciary duties of Managers could also be measured by reference to partnership law or the law of agency.¹³²⁸

By analogy to corporate directors, Managers would have the duties of obedience, care and loyalty and should have the benefit of the business judgment rule.¹³²⁹ Much like a corporate director who, in theory, represents all of the shareholders of the corporation rather than those who are responsible for his being a director, a Manager should be deemed to have a fiduciary duty to all of the Members. Whether Members owe a fiduciary duty to the other Members or the

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- (3) a transaction from which the person received an improper benefit, regardless of whether the benefit resulted from an action taken within the scope of the person's duties; or
 - (4) an act or omission for which the liability of a governing person is expressly provided by an applicable statute.
 - (d) The liability of a governing person may be limited or eliminated [~~restricted~~]:
 - (1) in a general partnership by its partnership agreement to the same extent Subsections (b) and (c) permit the limitation or elimination of liability of a governing person of an organization to which those subsections apply and to the additional extent permitted under Chapter 152;
 - (2) in a limited partnership by its partnership agreement to the same extent Subsections (b) and (c) permit the limitation or elimination of liability of a governing person of an organization to which those subsections apply and to the additional extent permitted under Chapter 153 and, to the extent applicable to limited partnerships, Chapter 152; and
 - (3) in a limited liability company by its certificate of formation or company agreement to the same extent Subsections (b) and (c) permit the limitation or elimination of liability of a governing person of an organization to which those subsections apply and to the additional extent permitted under Section 101.401.

Thus, the TBOC now allows the elimination of liabilities – to a specified and limited extent – but does not allow the elimination of fiduciary duties, although fiduciary duties may be expanded or reduced in a company agreement. Thus, in theory, equitable remedies may exist to address acts for which any monetary liability has been eliminated by a company agreement.

¹³²⁸ See American Law Institute, RESTATEMENT (SECOND) OF AGENCY § 13 (1958) (“An agent is a fiduciary with respect to matters within the scope of his agency”), 387 (“Unless otherwise agreed, an agent is subject to a duty to his principal to act solely for the benefit of the principal in all matters connected with his agency”), 393 (“Unless otherwise agreed, an agent is subject to a duty not to compete with the principal concerning the subject matter of his agency”), 394 (“Unless otherwise agreed, an agent is subject to a duty not to act or to agree to act during the period of his agency for persons whose interests conflict with those of the principal in matters in which the agent is employed”), and 395 (“Unless otherwise agreed, an agent is subject to a duty to the principal not to use or to communicate information confidentially given him by the principal or acquired by him during the course of or on account of his agency or in violation of his duties as agent, in competition with or to the injury of the principal, on his own account or on behalf of another, although such information does not relate to the transaction in which he is then employed, unless the information is a matter of general knowledge”). See also Elizabeth S. Miller, *Practical Pitfalls in Drafting Texas Limited Liability Company Agreements*, 45:1 TEX. J. BUS. L. 27 (2012) (“Absent provisions in the company agreement otherwise, managers and managing members would seemingly owe the common law fiduciary duties of an agent to the LLC as principal, even without resort to analogies to corporate or partnership law.”).

¹³²⁹ See *supra* notes 271-316 and related text.

LLC will likely be determined by reference to corporate principles in the absence of controlling provisions in the certificate of formation or Company Agreement.¹³³⁰

The Tex. LLC Stats. allow LLC Company Agreements to expand or restrict the duties (including fiduciary duties) and liabilities of Members, Managers, officers and other persons to the LLC or to Members or Managers of the LLC.¹³³¹ This provision of Texas law was designed, in the same vein as the DLLCA from which it drew inspiration, to allow LLCs the flexibility to address fiduciary duties through contract principles.¹³³² Unlike the DLLCA which allows an LLC agreement to eliminate fiduciary duties (but not the contractual duty of good faith and fair dealing),¹³³³ the Tex. LLC Stats. only permit an LLC Company Agreement to “restrict” duties,

¹³³⁰ See *Allen v. Devon Energy Holdings, L.L.C.*, 367 S.W.3d 355, 391-97 (Tex. App.—Houston [1st Dist.] 2012, Review Granted Judgment Set Aside and Remanded by Agreement (Jan. 11, 2013) by *Devon Energy Holdings v. Allen*, 2013 Tex. LEXIS 20 (Tex., Jan. 11, 2013) (Court declined to recognize a fiduciary duty of a majority member to a minority member generally since Texas does not recognize such a relationship between majority and minority shareholders in closely held corporations, but concluded that the majority member’s position as the controlling member and sole manager was sufficient to create a fiduciary duty to the minority member in a transaction in which the minority member’s interest was being redeemed; the Court also concluded that an exculpation provision in the LLC’s articles of organization referring to the manager’s “duty of loyalty to [the LLC] or its members” could be read to create a fiduciary duty to the members individually which would include a duty of candor to disclose material facts relating to the value of the interest to be redeemed) (*Allen* was distinguished by *Fazio v. Cypress*, 2012 Tex. App. LEXIS 6837, on disclaimer of reliance issue); *Suntech Processing Sys., L.L.C. v. Sun Communications, Inc.*, 2000 WL 1780236, at *6 (Tex. App.—Dallas Dec. 5, 2000, pet. denied) (not designated for publication) (minority Member of a Texas LLC claimed that the controlling Member owed a fiduciary duty as a matter of law in connection with the winding up of operations and distribution of assets; the Court pointed out that the Regulations expressly provided for a duty of loyalty to the LLC rather than between the Members, and, noting the absence of Texas case law on fiduciary duties of LLC Members and looking to case law regarding fiduciary duties of shareholders of a closely held corporation, held that there was no fiduciary relationship between the Members as a matter of law). See Elizabeth S. Miller, *Practical Pitfalls in Drafting Texas Limited Liability Company Agreements*, 45:1 TEX. J. BUS. L. 27, 46 (2012).

¹³³¹ See LLC Act § 2.20B; TBOC § 101.401. Prior to the effectiveness of 1997 S.B. 555 on September 1, 1997 (“1997 S.B. 555”), LLC Act § 8.12 had incorporated by reference the limitation of liability afforded to corporate directors under TMCLA 1302-7.06 and thereby allowed the limitation of Manager liability by a provision in the Articles (now, the Certificate of Formation) to the extent permitted for a director under TMCLA 1302-7.06. 1997 S.B. 555 deleted such incorporation by reference of TMCLA 1302-7.06 in favor of the broader authorization now in LLC Act § 2.20B, but a comparable provision was added back in TBOC § 7.001 as amended in 2013 by S.B. 847 § 2 as quoted *supra* in note 1327.

¹³³² DEL. CODE ANN. tit. 6, §§ 18-1101(a)-(f) (2013).

¹³³³ In Texas a common-law duty of good faith and fair dealing does not exist in all contractual relationships. *Blackmon-Dunda v. Mary Kay, Inc.*, 2009 WL 866214 (Tex.App.-Dallas April 1, 2009, pet. denied). Rather, the duty arises only when a contract creates or governs a special relationship between the parties. *Subaru of Am. v. David McDavid Nissan*, 84 S.W.3d 212, 225 (Tex. 2002). A “special relationship” has been recognized where there is unequal bargaining power between the parties and a risk exists that one of the parties may take advantage of the other based upon the imbalance of power, e.g., insurer-insured (see *Arnold v. Nat’l County Mut. Fire Ins. Co.*, 725 S.W.2d 165, 167 (Tex. 1987)). The elements which make a relationship special are absent in the relationship between an employer and an employee. See *City of Midland v. O’Bryant*, 18 S.W.3d 209, 215 (Tex. 2000). While there are no reported Texas cases as to whether a contractual duty of good faith and fair dealing exists between Members in an LLC, or between Managers and Members in a Texas LLC, it is likely that the duty of good faith and fair dealing exists in those LLC relationships, just as fiduciary duties likely exist, except in each case to the extent that the duty has been restricted by contract as permitted by the Tex. LLC Stats. See *supra* note 1327 and related text.

but allow the elimination of liability for breach of fiduciary duties (other than the duty of loyalty).¹³³⁴

The contractual elimination or restriction of fiduciary duties is an important developing issue in the context of fiduciary duties for Texas LLCs. The Texas Legislature in 2013 amended TBOC § 7.001(d)(3) to expand the permitted contractual limitation or elimination of liabilities for monetary damages for breach of fiduciary duties by Members and Managers of Texas LLCs, but does not allow the elimination of liabilities for breaches of the duty of loyalty or acts or omissions not in good faith.¹³³⁵

A Company Agreement provision restricting fiduciary duties and limiting liability for breaches thereof as permitted by TBOC §§ 7.001 and 101.401 could read as follows:

This Agreement is not intended to, and does not, create or impose any fiduciary duty on any Member or Manager. Furthermore, each of the Members, the Managers and the Company hereby, to the fullest extent permitted by Applicable Law [defined to mean the TBOC and other applicable Texas and federal statutes and regulations thereunder], restricts, limits, waives and eliminates any and all duties, including fiduciary duties, that otherwise may be implied by Applicable Law and, in doing so, acknowledges and agrees that the duties and obligations of each Member or Manager to each other and to the Company are only as expressly set forth in this Agreement and that no Member or Manager shall have any liability to the Company or any other Member or Manager for any act or omission except as specifically provided by Applicable Law or in this Agreement or another written agreement to which the Member or Manager is a party. The provisions of this Agreement, to the extent that they restrict, limit, waive and eliminate the duties and liabilities of a Member or Manager otherwise existing at law or in equity, are agreed by the Members to replace such other duties and liabilities of such Members or Managers.

Notwithstanding anything to the contrary contained in this Agreement,

(1) the Managers shall not permit or cause the Company to engage in, take or cause any of the following actions except with the prior approval of a majority of the outstanding Units voting: *[list specific actions]*:

(2) the Members and Managers and each of their respective Affiliates are permitted to have, and may presently or in the future have, investments or other business relationships, ventures, agreements or arrangements (i) with entities engaged in the business of the Company, other than through the Company (an “Other Business”) and (ii) with *[additional entity specifics]*; *[provided, that any transactions between the Company and an Other Business will be on terms no less*

¹³³⁴ See *supra* note 1327 and related text.

¹³³⁵ See *supra* note 1327 and related text.

favorable to the Company than would be obtainable in a comparable arm's-length transaction];¹³³⁶ and

(3) there shall be a presumption by the Company that any actions taken in good faith by the Manager on behalf of the Company shall not violate any fiduciary or other duties owed by the Managers to the Company or the Members.¹³³⁷

Provisions such as the foregoing are often subject to intense negotiations and some investors may not agree to the limitations on duties and liabilities that those in control propose.

Although the Tex. LLC Stats., unlike their Delaware counterpart, do not include provisions that expressly emphasize the principles of freedom of contract and enforceability of LLC Company Agreements that expand, restrict or eliminate liability for breach of fiduciary duties, the legislative history and scope of LLC Act § 2.20B, the precursor to TBOC § 101.401, indicate that even before the 2013 Legislative Session there was more latitude to exculpate Managers and Members for conduct that would otherwise breach a fiduciary duty under the Tex. LLC Stats. than under provisions of the TBOC and the TBCA relating specifically to corporations.¹³³⁸

The Tex. LLC Stats., which are based on TBCA article 2.35-1, provide that, unless the articles of organization, certificate of formation, Regulations or Company Agreement provide otherwise, a transaction between an LLC and one or more of its Managers or officers, or between

¹³³⁶ See *infra* notes 1343-1347 and related text for cases holding that wording such as this provision may contractually import the common law fiduciary duty of loyalty in Delaware

¹³³⁷ S.B. 847 in the 2013 Legislative Session amended TBOC § 7.001(d)(3) to read as follows:

(d) The liability of a governing person may be limited or eliminated [~~restricted~~]:

* *

(3) in a limited liability company by its certificate of formation or company agreement to the same extent Subsections (b) and (c) permit the limitation or elimination of liability of a governing person of an organization to which those subsections apply and to the additional extent permitted under Section 101.401 [The company agreement of a limited liability company may expand or restrict any duties, including fiduciary duties, and related liabilities that a member, manager, officer, or other person has to the company or to a member or manager of the company.].

See supra note 1327.

¹³³⁸ In Texas a common-law duty of good faith and fair dealing does not exist in all contractual relationships. *Blackmon-Dunda v. Mary Kay, Inc.*, No. 05-08-00192-CV, 2009 WL 866214, at*1 (Tex. App.—Dallas April 1, 2009, pet. denied). Rather, the duty arises only when a contract creates or governs a special relationship between the parties. *Subaru of Am. v. David McDavid Nissan*, 84 S.W.3d 212, 225 (Tex. 2002). A “special relationship” has been recognized where there is unequal bargaining power between the parties and a risk exists that one of the parties may take advantage of the other based upon the imbalance of power, e.g., insurer-insured (*see Arnold v. Nat’l County Mut. Fire Ins. Co.*, 725 S.W.2d 165, 167 (Tex.1987)). The elements which make a relationship special are absent in the relationship between an employer and an employee. *See City of Midland v. O’Bryant*, 18 S.W.3d 209, 215 (Tex. 2000). While there are no reported Texas cases as to whether a contractual duty of good faith and fair dealing exists between Members in an LLC, or between Managers and Members in a Texas LLC, it is likely that the duty of good faith and fair dealing exists in those LLC relationships, just as fiduciary duties likely exist, except in each case to the extent that the duty has been restricted by contract as permitted by the Tex. LLC Stats.

an LLC and any other LLC or other entity in which one or more of its Managers or officers are Managers, directors or officers or have a financial interest, shall be valid notwithstanding the fact that the Manager or officer is present or participates in the meeting of Managers, or signs a written consent, which authorizes the transaction or the Manager's votes are counted for such purpose, if any of the following is satisfied:

(i) The material facts as to the transaction and interest are disclosed or known to the governing authority, and the governing authority in good faith authorizes the transaction by the approval of a majority of the disinterested Managers or Members (as appropriate) even though the disinterested Managers or Members are less than a quorum; or

(ii) The material facts as to the transaction and interest are disclosed or known to the Members, and the transaction is approved in good faith by a vote of the Members; or

(iii) The transaction is fair to the LLC as of the time it is authorized, approved or ratified by the Managers or Members.¹³³⁹

In a joint venture, the duty of a Manager to all Members could be an issue since the Managers would often have been selected to represent the interests of particular Members. The issue could be addressed by structuring the LLC to be managed by Members who would then appoint representatives to act for them on an operating committee which would run the business in the name of the Members. In such a situation, the Members would likely have fiduciary duties analogous to partners in a general partnership.¹³⁴⁰

5.4.2. Delaware. The DLLCA does not codify Manager or Member fiduciary duties, but expressly permits the elimination of fiduciary duties in an LLC,¹³⁴¹ although not all Delaware

¹³³⁹ LLC Act § 2.17; TBOC § 101.255 as amended in the 2009 Legislative Session by 2009 S.B. 1442 § 44 and in the 2011 Legislative Session by 2011 S.B. 748 § 38.

¹³⁴⁰ *Id.*; see TRPA § 4.04; see also TBOC § 152.204.

¹³⁴¹ DLLCA § 18-1101(b), (c), (d) and (e) provides:

(b) It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.

(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.

(d) Unless otherwise provided in a limited liability company agreement, a member or manager or other person shall not be liable 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 for breach of fiduciary duty for the member's or manager's or other person's good faith reliance on the provisions of the limited liability company agreement.

LLC agreements effectively do so.¹³⁴² In *Auriga Capital Corp. v. Gatz Properties, LLC*,¹³⁴³ Delaware Chancellor Strine, in finding for the minority investors who had challenged the merger of the LLC into an entity controlled by the Manager, held that the LLC agreement contractually incorporated a core element of the traditional common law fiduciary duty of loyalty by providing

(e) A limited liability company agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a member, manager or other person 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; provided, that a limited liability company agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.

¹³⁴²

In re Atlas Energy Resources LLC, C.A. No. 4589-VCN, 2010 WL 4273122 (Del Ch. Oct. 28, 2010), involved breach of fiduciary duty claims arising from a merger between a publicly traded LLC and its controlling unitholder. In *In re Atlas*, the Chancery Court held that an LLC agreement eliminated the traditional fiduciary duties of the LLC's directors and officers, replacing them with a contractually-defined duty of good faith, which was not breached, but did not address the duties of the controlling unitholder, which were held to be equivalent to those of a controlling shareholder of a Delaware corporation. The Court commented that LLCs are creatures of contract designed to afford the maximum amount of freedom of contract, private ordering, and flexibility to the parties involved. One aspect of this flexibility, the Court wrote, is that parties to an LLC agreement can contractually expand, restrict, modify or fully eliminate the fiduciary duties owed by its members, subject to certain limitations, but in the absence of explicit provisions in the LLC agreement to the contrary, the traditional fiduciary duties owed by corporate directors and controlling shareholders apply in the LLC context. Because this LLC agreement did not eliminate the fiduciary duties of the controlling unitholder, it owed directly to the LLC's minority unitholders the traditional fiduciary duties that controlling shareholders owe minority shareholders. Since the merger created a conflict between the controlling unitholder's interest in acquiring the balance of the LLC for the lowest possible price and the minority unitholders' interest in obtaining a high price for their units and the LLC agreement did not address this conflict of interest, the Court evaluated the merger under the entire fairness standard of review in order to assure that the controlling unitholder "has been assiduous in fulfilling those duties," held that "plaintiffs' allegations as to price and process, adequately suggest that the merger was not entirely fair to the public unitholders," and denied defendants' motion to dismiss the claim for breach of fiduciary duty by the controlling unitholder.

DLLCA § 18-1101(e) was followed in *In re Heritage Org., LLC*, No. 04-35574-BJH-11, 2008 WL 5215688 (Bankr. N.D. Tex. Dec. 12, 2008), which involved a bankruptcy trustee's breach of fiduciary duty claims against former officers of a bankrupt Delaware LLC which had an LLC agreement that eliminated fiduciary duties in the following sweeping language:

The Manager shall not be required to exercise any particular standard of care, nor shall he owe any fiduciary duties to the Company or the other Members. Such excluded duties include, by way of example, not limitation, any duty of care, duty of loyalty, duty of reasonableness, duty to exercise proper business judgment, duty to make business opportunities available to the company, and any other duty which is typically imposed upon corporate officers and directors, general partners or trustees. The Manager shall not be held personally liable for any harm to the Company or the other Members resulting from any acts or omissions attributed to him. Such acts or omissions may include, by way of example but not limitation, any act of negligence, gross negligence, recklessness, or intentional misconduct.

Faced with this broad clause, the bankruptcy court in *Heritage* held that the defendants had no fiduciary duties to breach, and thus rejected the trustee's breach of fiduciary duty claim. *Cf. Kahn v. Portnoy*, 2008 WL 5197164 (Del. Ch. December 11, 2008) (under freedom of contract principles, fiduciary duties held to be defined, but not eliminated, by LLC agreement).

¹³⁴³

40 A.3d 839 (Del. Ch. 2012), *aff'd*, 59 A.3d 1206 (Del. 2012).

that the Manager could enter into a self-dealing transaction (such as its purchase of the LLC) only if it proved that the terms were fair. The LLC agreement provided that, without the consent of the holders of two-thirds of the interests not held by the Manager or its affiliates, the Manager would not be entitled to cause the LLC to enter into any transaction with an affiliate that is less favorable to the LLC than that which could be entered into with an unaffiliated third party. The LLC agreement's exculpation provision provided that the Manager would not be liable to the LLC for actions taken or omitted by the Manager in good faith and without gross negligence or willful misconduct. As the LLC agreement's exculpatory provision expressly did not excuse bad faith action, willful misconduct, or even grossly negligent action, by the LLC Manager, the Manager was liable for the losses caused by its flawed merger. The Chancellor mused that under traditional principles of equity applicable to an LLC and in the absence of a contrary LLC agreement provision, a Manager of an LLC would owe to the LLC and its members the common law fiduciary duties of care and loyalty.

The Delaware Supreme Court affirmed *Auriga* in *Gatz Properties, LLC v. Auriga Capital Corp.*,¹³⁴⁴ holding that although the LLC agreement did not use words such as "entire fairness" or "fiduciary duties," there was nonetheless an explicit contractual assumption by the parties of an obligation on the part of the Manager and Members of the LLC to obtain a fair price for the LLC in transactions between the LLC and affiliates, but the Supreme Court expressly rejected the Chancellor's conclusion that the fiduciary duties were "default" fiduciary duties:

The pivotal legal issue presented on this appeal is whether Gatz owed contractually-agreed-to fiduciary duties to Peconic Bay [the LLC] and its minority investors. Resolving that issue requires us to interpret Section 15 of the LLC Agreement, which both sides agree is controlling. Section 15 pertinently provides that:

Neither the Manager nor any other Member shall be entitled to cause the Company to enter into any amendment of any of the Initial Affiliate Agreements which would increase the amounts paid by the Company pursuant thereto, or enter into any additional agreements with affiliates on terms and conditions which are less favorable to the Company than the terms and conditions of similar agreements which could then be entered into with arms-length third parties, without the consent of a majority of the non-affiliated Members (such majority to be deemed to be the holders of 66-2/3% of all Interests which are not held by affiliates of the person or entity that would be a party to the proposed agreement).

The Court of Chancery determined that Section 15 imposed fiduciary duties in transactions between the LLC and affiliated persons. We agree. To impose fiduciary standards of conduct as a contractual matter, there is no

¹³⁴⁴ 59 A.3d 1206 (Del. 2012), *aff'd* 40 A.3d 839; see Jessica Liou, *Fiduciary Duty Bound (Part 1): "Default" Fiduciary Duties Apply in Delaware LLC's...Or Maybe They Don't*, Weil Bankruptcy Blog, Mar. 8, 2013, <http://business-finance-restructuring.weil.com/fiduciary-duties/fiduciary-duty-bound-part-1-default-fiduciary-duties-apply-in-delaware-llcs-or-maybe-they-dont/>.

requirement in Delaware that an LLC agreement use magic words, such as “entire fairness” or “fiduciary duties.” Indeed, Section 15 nowhere expressly uses either of those terms. Even so, we construe its operative language as an explicit contractual assumption by the contracting parties of an obligation subjecting the manager and other members to obtain a fair price for the LLC in transactions between the LLC and affiliated persons. Viewed functionally, the quoted language is the contractual equivalent of the entire fairness equitable standard of conduct and judicial review.

We conclude that Section 15 of the LLC Agreement, by its plain language, contractually adopts the fiduciary duty standard of entire fairness, and the “fair price” obligation which inheres in that standard. Section 15 imposes that standard in cases where an LLC manager causes the LLC to engage in a conflicted transaction with an affiliate without the approval of a majority of the minority members. There having been no majority-of-the-minority approving vote in this case, the burden of establishing the fairness of the transaction fell upon Gatz. That burden Gatz could easily have avoided. If (counterfactually) Gatz had conditioned the transaction upon the approval of an informed majority of the nonaffiliated members, the sale of Peconic Bay would not have been subject to, or reviewed under, the contracted-for entire fairness standard.

* * *

Entire fairness review normally encompasses two prongs, fair dealing and fair price. “However, the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness.” In this case, given the language of Section 15 which speaks only in terms of fair price, the Court of Chancery formally applied only the fair price prong. But, in doing so that court also properly considered the “fairness” of how Gatz dealt with the minority “because the extent to which the process leading to the self-dealing either replicated or deviated from the behavior one would expect in an arms-length deal bears importantly on the price determination.” The court further held that “in order to take cover under the contractual safe harbor of Section 15, Gatz bears the burden to show that he paid a fair price to acquire [the LLC].

* * *

Although the trial court’s adjudication subjects Gatz to liability under Section 15 of the LLC Agreement, another provision, Section 16, permits both exculpation and indemnification of Peconic Bay’s manager in specified circumstances. Gatz, however, did not cause those circumstances to come about. Having failed to satisfy the criteria of Section 16, Gatz was not eligible for exculpation or indemnification, and the Court of Chancery properly so held.

Section 16 of the LLC Agreement pertinently provides:

No Covered Person [defined to include, among others, the members, manager, and officers and the employees] shall be liable to the Company, [or] any other Covered Person or any other person or entity who has an interest in the Company for any loss, damage or claim incurred by reason of any act or omission performed or omitted by such Covered Person in good faith in connection with the formation of the Company or on behalf of the Company and in a manner reasonably believed to be within the scope of the authority conferred on such Covered Person by this Agreement, except that a Covered Person shall be liable for any such loss, damage or claim incurred by reason of such Covered Person's gross negligence, willful misconduct or willful misrepresentation.

Gatz was not entitled to exculpation because the Court of Chancery properly found that he had acted in bad faith and had made willful misrepresentations in the course of breaching his contracted-for fiduciary duty. Consequently, Section 16 of the LLC Agreement provides no safe harbor.

* * *

At this point, we pause to comment on one issue that the trial court should not have reached or decided. We refer to the court's pronouncement that the Delaware Limited Liability Company Act imposes "default" fiduciary duties upon LLC managers and controllers unless the parties to the LLC Agreement contract that such duties shall not apply. Where, as here, the dispute over whether fiduciary standards apply could be decided solely by reference to the LLC Agreement, it was improvident and unnecessary for the trial court to reach out and decide, *sua sponte*, the default fiduciary duty issue as a matter of statutory construction. The trial court did so despite expressly acknowledging that the existence of fiduciary duties under the LLC Agreement was "no longer contested by the parties." For the reasons next discussed, that court's statutory pronouncements must be regarded as dictum without any precedential value.

First, the Peconic Bay LLC Agreement explicitly and specifically addressed the "fiduciary duty issue" in Section 15, which controls this dispute. Second, no litigant asked the Court of Chancery or this Court to decide the default fiduciary duty issue as a matter of statutory law. In these circumstances we decline to express any view regarding whether default fiduciary duties apply as a matter of statutory construction. The Court of Chancery likewise should have so refrained.

While the Supreme Court opinion in *Gatz* did not resolve the issue of whether fiduciary duties would be implied in the absence of the contractual elimination or modification of fiduciary duties in the LLC agreement,¹³⁴⁵ the Delaware Court of Chancery subsequently "considered the issue of default fiduciary duties and held that, subject to clarification from the Supreme Court,

¹³⁴⁵ See *infra* note 1344 and related text.

managers and managing members of an LLC do owe fiduciary duties as a default matter.”¹³⁴⁶ Further, the DLLCA has been amended, effective August 1, 2013, to provide that unless modified in an LLC’s governing documents, common law fiduciary duties apply to LLCs.¹³⁴⁷

¹³⁴⁶

Zimmerman v. Adhezion Biomedical LLC, C.A. No. 6001-VCP, at *44 (Del. Ch. Jan. 31, 2013) (*emphasis added*), referencing *Feeley v. NHAOCG, LLC*, 2012 WL 5949209, at *8-10 (Del. Ch. Nov. 28, 2012). In *Zimmerman*, Robert Zimmerman, co-founder and former CEO of Adhezion, sued the current majority owners, alleging breach of the LLC Agreement (failure to obtain consent of the common members) and fiduciary duties (self-dealing transactions) when such majority owners caused Adhezion to enter into certain financing transactions. The majority owners denied any fundamental breach of fiduciary duty, and argued, in any event, that the LLC Agreement proscribed an applicable standard of review (the business judgment rule), which they contend they did not breach.

The Court of Chancery found that the majority owners did breach the LLC Agreement in issuing units without written consent, involving a detailed analysis of the LLC Agreement, which the Court found to be an unusually ambiguous contract. It also noted that the LLC Agreement imposed duties of good faith (to act with an objective standard of reasonableness) and enumerated specific safe harbors for intercompany dealings; and accordingly, because the Court found that (i) Zimmerman failed to show that the financing transactions were unfair to Adhezion and (ii) the financing transactions were approved in compliance with the requisite safe harbor, the Court held that the majority owners had not breached their contracted-for fiduciary duties to the company. With respect to this latter finding, the Court of Chancery specifically distinguished *Auriga*, which placed the burden of proving the fairness of the self-dealing transaction on the LLC manager (because of language in the LLC Agreement prohibited such a manager from entering into self-dealing transaction without the consent of the other managers), as opposed to the LLC Agreement in *Zimmerman*, which gave members, directors, or officers the affirmative right to engage in transactions with the company, so long as such a transaction was comparable to a third-party one. Ultimately, the Court awarded Zimmerman \$1 for his successful breach of contract claim with respect to the majority owners’ failure to obtain written consent and otherwise found that the majority owners were protected by the indemnification provisions of the LLC Agreement with respect to Zimmerman’s requests for attorneys’ fees advanced by Adhezion on behalf of the majority owners.

See also Kelly v. Blum, 2010 WL 629850 (Del.Ch. February 24, 2010), the Chancery Court denied motions for summary judgment, dealing with (among other things) fiduciary duties in a merger challenged by a minority Member/Manager of an LLC who was squeezed out in a merger into a sister company of the majority Member. The Court held that: (i) the claims of the minority were direct rather than derivative, (ii) the Managers and majority Members owed traditional fiduciary duties to the minority Member in the absence of any express provisions in the operating agreement to limit fiduciary duties, and (iii) the corporate parent of the majority Member and the surviving Member could be liable for aiding and abetting breaches of fiduciary duty. In so holding, the Court explained:

Though few Delaware cases deal specifically with the distinction between derivative and direct claims in the LLC context, Sections 18-1001 to 18-1004 of the Delaware Limited Liability Company Act (“LLC Act”) were modeled, in significant part, on the corporate derivative suit. Consequently, “case law governing corporate derivative suits is equally applicable to suits on behalf of an LLC,” and I look to corporate case law to determine the proper method for distinguishing between derivative actions brought on behalf of Marconi and Kelly’s direct claims.

The distinction between the rights of an LLC and the individual rights of its members is often quite narrow. Though several early Delaware cases addressing this distinction relied largely on the “amorphous and confusing concept of ‘special injury,’” the Delaware Supreme Court expressly disavowed use of that concept in *Tooley*. In *Tooley*, the Court stated that determining whether a claim is derivative or direct depends solely upon two questions: First, “who suffered the alleged harm,” the LLC or its members, and second, “who would receive the benefit of any recovery or other remedy,” the LLC or its members, individually. In answering these questions, the Court looks to the nature of the wrong alleged, not merely at the form of words used in the complaint.

In the second count of the Complaint, Kelly claims that, by virtue of their status as Members or Managers of Marconi, Defendants Blum, Breen, Kestenbaum, MBC Investment, and MBC Lender each “owed various fiduciary duties to Kelly as the minority equity owner.” Kelly further avers that these Defendants violated their duties of loyalty and care to him by entering into a self-interested Merger on terms that were unfair to Kelly.

The basic approach of the LLC Act is to “provide members with broad discretion in drafting the [LLC] Agreement and to furnish default provisions when the members’ agreement is silent.” In the case of fiduciary duties, the LLC Act permits LLC contracting parties to expand, restrict, or eliminate duties, including fiduciary duties, owed by members and managers to each other and to the LLC. Section 18-1101(c) does not specify a statutory default provision as do other sections of the LLC Act; rather, it implies that some default fiduciary duties may exist “at law or in equity,” inviting Delaware courts to make an important policy decision and determine the default level of those duties.

Accepting that invitation, Delaware cases interpreting Section 18-1101(c) have concluded that, despite the wide latitude of freedom of contract afforded to contracting parties in the LLC context, “in the absence of a contrary provision in the LLC agreement,” LLC managers and members owe “traditional fiduciary duties of loyalty and care” to each other and to the company. Thus, unless the LLC agreement in a manager-managed LLC explicitly expands, restricts, or eliminates traditional fiduciary duties, managers owe those duties to the LLC and its members and controlling members owe those duties to minority members. Therefore, I must determine whether the 2008 LLC Agreement expanded, restricted, or eliminated the default fiduciary duties the Managers (Blum, Breen, and Kestenbaum) and controlling Members (MBC Investment and MBC Lender) owed to Kelly, and whether a breach of any existing duty would support a direct, as opposed to a derivative, claim.

In large measure, the 2008 LLC Agreement is silent on the issue of duties owed by Managers to the LLC and its Members, with the exception of Sections 7.5 and 7.9. In its entirety, Section 7.5, entitled “Duties,” states that

[t]he Board of Managers shall manage the affairs of the Company in a prudent and business-like manner and shall devote such time to the Company affairs as they shall, in their discretion exercised in good faith, determine is reasonably necessary for the conduct of such affairs.

In relevant part, Section 7.9, which limits the monetary liability of Managers, states that

[i]n carrying out their duties hereunder, the Managers shall not be liable for money damages **for breach of fiduciary duty to the Company nor to any Member** for their good faith actions or failure to act ... but only for their own willful or fraudulent misconduct or willful breach of their contractual or **fiduciary duties** under this Agreement.

(Emphasis added).

I do not read these clauses, individually or collectively, as “explicitly disclaim[ing or limiting] the applicability of default principles of fiduciary duty.” Indeed, far from limiting such duties, Section 7.9 suggests that the parties intended traditional fiduciary duties to apply. Additionally, Section 7.5 does not limit the Managers’ duties so much as place control of Marconi’s affairs in the board of Managers, rather than the Members, allowing each Manager the discretion to determine the amount of time she must devote to running Marconi.

Because no clause in the 2008 LLC Agreement explicitly restricts or eliminates the default applicability of fiduciary duties, I find that Blum, Breen, and Kestenbaum, as Managers of Marconi, were required to treat Kelly in accordance with such traditional fiduciary duties. Furthermore, if the allegations in Kelly’s Complaint are true, then Blum,

Breen, and Kestenbaum entered the Merger largely intending to profit from a “premeditated scheme to squeeze Kelly out of Marconi and seize control of the FCC license” held by Marconi-actions that support a claim for breach of the duty of loyalty. Thus, drawing reasonable inferences in Kelly's favor, I find that his Complaint alleges sufficient facts to support his claim that the Managers breached these duties by entering into a Merger designed solely to eliminate Kelly’s interest in Marconi.

Even though Kelly alleged facts that, if true, are sufficient to show that Blum, Breen, and Kestenbaum may have breached their fiduciary duties, those Defendants still might avoid liability because the 2008 LLC Agreement contains an exculpatory provision limiting the monetary liability of Managers. Section 18-1101(e) of the LLC Act permits members, in their LLC agreement, to limit or eliminate a manager’s or member’s liability for “breach of contract and breach of duties (including fiduciary duties),” except for liability arising from a “bad faith violation of the implied contractual covenant of good faith and fair dealing.” While somewhat analogous to 8 *Del. C.* § 102(b)(7), which authorizes a corporation to adopt provisions limiting liability for a director’s breach of the duty of care, Section 18-1101(e) goes further by allowing broad exculpation of *all* liabilities for breach of fiduciary duties-including the duty of loyalty.

Here, Section 7.9 of the 2008 LLC Agreement eliminates the Managers’ monetary liability for all conduct except “willful or fraudulent misconduct or willful breach of ... contractual or fiduciary duties under this Agreement.” Although the default duties of loyalty and care remain, this provision requires more than application of a standard like entire fairness and requires that Kelly allege facts showing scienter. That is, under Section 7.9, liability attaches only where a Manager willfully breaches his fiduciary duties.

* * *

As with LLC managers, “in the absence of provisions in the LLC agreement explicitly disclaiming the applicability of default principles of fiduciary duty,” controlling members in a manager-managed LLC owe minority members “the traditional fiduciary duties” that controlling shareholders owe minority shareholders. Controlling shareholders-typically defined as shareholders who have voting power to elect directors, cause a break-up of the company, merge the company with another, or otherwise materially alter the nature of the corporation and the public shareholder’s interests-owe certain fiduciary duties to minority shareholders. Specifically, and very pertinently to this case, such fiduciary duties include the duty “not to cause the corporation to effect a transaction that would benefit the fiduciary at the expense of the minority stockholders.”

* * *

Because the 2008 LLC Agreement is silent as to what duties controlling members owe minority members, I find that MBC Investment and MBC Lender owed Kelly traditional fiduciary duties, including, among others, the duty not to cause Marconi to enter a transaction that would benefit the controlling Members at the expense of Kelly, Marconi’s minority Member. I also find that Kelly has stated facts that, if true, are sufficient to show that MBC Investment and MBC Lender did, with the aid of their appointed Managers, effect the Merger in order to benefit themselves at the expense of Kelly. Thus, Kelly has stated a direct claim that is not subject to any exculpation provision in the Agreement, and I deny Defendants’ motion to dismiss Count II of Kelly’s Complaint as to MBC Investment and MBC Lender.

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DLLCA § 18-1104 was amended, effective August 1, 2013, as follows: “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, shall govern.” [new language underlined]. The synopsis accompanying the amendment in Delaware H.B. 126 explains it as follows:

Section 8 amends Section 18-1104 to confirm that in some circumstances fiduciary duties not explicitly provided for in the limited liability company agreement apply. For example, a manager of a manager-managed limited liability company would ordinarily

The DLLCA aggressively adopts a “contracterian approach” (i.e., the bargains of the parties manifested in LLC agreements are to be respected and rarely trumped by statute or common law).¹³⁴⁸ The DLLCA does not have any provision which itself creates or negates

have fiduciary duties even in the absence of a provision in the limited liability company agreement establishing such duties. Section 18-1101(c) continues to provide that such duties may be expanded, restricted or eliminated by the limited liability company agreement.

¹³⁴⁸

In *Fisk Ventures, LLC v. Segal*, 2008 WL 1961156 (Del. Ch. 2008), *judgment aff'd* 984 A.2d 124 (Del. 2009), Delaware Chancellor William Chandler wrote that LLCs are creatures of contract and that a prerequisite to any breach of contract analysis is to determine if there is a *duty* in the document that has been breached. The Chancellor quoted in footnote 34 Chief Justice Steele’s article entitled *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 Del. J. Corp. L. 1, 4 (2007) (“Courts should recognize the parties’ freedom of choice exercised by contract and should not superimpose an overlay of common law fiduciary duties...”), and found no provision in the LLC Agreement at issue that: “create[d] a code of conduct for all members; on the contrary, most of those sections expressly claim to limit or waive liability.” The Chancellor wrote:

There is no basis in the language of the LLC Agreement for Segal’s contention that all members were bound by a code of conduct, but, even if there were, this Court could not enforce such a code because there is no limit whatsoever to its applicability”.

In addressing the breach of fiduciary duty claims asserted by plaintiff, the Chancellor focused on DLLCA § 18-1101(c) which allows for the complete elimination of all fiduciary duties in an LLC agreement. The Court then read the subject LLC Agreement to eliminate fiduciary duties because it flatly stated that:

No Member shall have any duty to any Member of the Company except as expressly set forth herein or in other written agreements. No Member, Representative, or Officer of the Company shall be liable to the Company or to any Member for any loss or damage sustained by the Company or to any Member, unless the loss or damage shall have been the result of gross negligence, fraud or intentional misconduct by the Member, Representative, or Officer in question....

Because the foregoing LLC Agreement exception for gross negligence, fraud or intentional misconduct did not create a fiduciary duty and the LLC Agreement did not otherwise expressly articulate fiduciary obligations, the foregoing LLC Agreement provision was held to be sufficient to eliminate defendant’s fiduciary duties.

The Chancellor considered and disposed of plaintiff’s “implied covenant of good faith and fair dealing” claim as follows:

Every contract contains an implied covenant of good faith and fair dealing that “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 bargain.” Although occasionally described in broad terms, the implied covenant is not a panacea for the disgruntled litigant. In fact, it is clear that “a court cannot and should not use the implied covenant of good faith and fair dealing to fill a gap in a contract with an implied term unless it is clear from the contract that the parties would have agreed to that term had they thought to negotiate the matter.” Only rarely invoked successfully, the implied covenant of good faith and fair dealing protects the spirit of what was *actually bargained and negotiated for* in the contract. Moreover, because the implied covenant is, by definition, *implied*, and because it protects the *spirit* of the agreement rather than the form, it cannot be invoked where the contract itself expressly covers the subject at issue.

Here, Segal argues that Fisk, Rose and Freund breached the implied covenant of good faith and fair dealing by frustrating or blocking the financing opportunities proposed by Segal. However, neither the LLC Agreement nor any other contract endowed him with the right to unilaterally decide what fundraising or financing opportunities the Company should pursue, and his argument is “another in a long line of cases in which a plaintiff has

Member or Manager fiduciary duties, but instead allows modification or elimination of fiduciary duties¹³⁴⁹ by an LLC agreement,¹³⁵⁰ but does not allow the elimination of “the implied

tried, unsuccessfully, to argue that the implied covenant grants [him] a substantive right that [he] did not extract during negotiation.” Moreover, the LLC Agreement *does* address the subject of financing, and its specifically requires the approval of 75% of the Board. Implicit in such a requirement is the right of the Class B Board representatives to disapprove of and therefore block Segal’s proposals. As this Court has previously noted, “[t]he mere exercise of one’s contractual rights, without more, cannot constitute ... a breach [of the implied covenant of good faith and fair dealing].” Negotiating forcefully and within the bounds of rights granted by the LLC agreement does not translate to a breach of the implied covenant on the part of the Class B members.

In *Related Westpac LLC v. JER Snowmass LLC*, C.A. No. 5011-VCS, 2010 WL 2929708 (Del. Ch. July 23, 2010), the Delaware Chancery Court held that one Member of an LLC could not force another to advance funds in a joint redevelopment project and consent to related projects, finding that the partner’s refusal was permitted by the project’s operating agreements. In so deciding, the Court refused to find that a condition of reasonableness to the right to refuse consent:

In this decision, I dismiss the complaint. Under the operating agreements that govern the LLCs, the defendant member could not unreasonably withhold its consent to certain decisions. But as to the type of decisions at issue in this case — so-called “material actions” — the defendant member was not subject to such a constraint and had contractually bargained to remain free to give or deny its consent if that was in its own commercial self-interest. Here, the plaintiff operating member seeks to have the court impose a contractual reasonableness overlay on a contract that is clearly inconsistent with the parties’ bargain. Delaware law respects contractual freedom and requires parties like the operating member to adhere to the contracts they freely enter. The operating agreements here preclude the relief the operating member seeks, including its attempt to end-run the operating agreements by arguing that the defendant member had a fiduciary duty to act reasonably in granting consent. Under the plain terms of the operating agreements, the defendant member had bargained for the right to give consents to decisions involving material actions or not, as its own commercial interests dictated. Having bargained for that freedom and gained that concession from the operating member, the defendant member is entitled to the benefit of its bargain and the operating member cannot attempt to have the court write in a reasonableness condition that the operating member gave up. The words “not unreasonably withheld” are well known and appear in other sections of the operating agreements. They do not qualify the defendant member’s right to deny consent to major decisions involving a material action.

Likewise, the operating agreements clearly state the sole remedy the operating member has if the defendant member fails to meet a capital call. The operating member again seeks to have this court impose a remedy inconsistent with the plain terms of the operating agreements. This court cannot play such a role, and the operating member’s claims relating to the capital call are dismissed because they are inconsistent with the operating agreements.

¹³⁴⁹ Section 18-1101 of the Delaware Limited Liability Company Act provides as follows:

18-1101 CONSTRUCTION AND APPLICATION OF CHAPTER AND LIMITED LIABILITY COMPANY AGREEMENT.

(a) The rule that statutes in derogation of the common law are to be strictly construed shall have no application to this chapter.

(b) It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.

(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

contractual covenant of good faith and fair dealing.”¹³⁵¹ An LLC agreement eliminating fiduciary duties as permitted by the DLLCA could read as follows:

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.

(d) Unless otherwise provided in a limited liability company agreement, a member or manager or other person shall not be liable 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 for breach of fiduciary duty for the member’s or manager’s or other person’s good faith reliance on the provisions of the limited liability company agreement.

(e) A limited liability company agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a member, manager or other person 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; provided, that a limited liability company agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.

(f) Unless the context otherwise requires, as used herein, the singular shall include the plural and the plural may refer to only the singular. The use of any gender shall be applicable to all genders. The captions contained herein are for purposes of convenience only and shall not control or affect the construction of this chapter.

¹³⁵⁰ See Myron T. Steele, *Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies*, 32 DEL. J. CORP. L. 1, 25 (2007), in which Delaware Supreme Court Chief Justice Steele argues that parties forming limited liability companies should be free to adopt or reject some or all of the fiduciary duties recognized at common law, that courts should look to the parties’ agreement and apply a contractual analysis, rather than analogizing to traditional notions of corporate governance, in LLC fiduciary duty cases, and that:

Delaware’s Limited Liability Company Act does not specify the duties owed by a member or manager. It does, however, like the Limited Partnership Act, provide for a default position “to the extent, at law or in equity” limited liability companies have “duties (including fiduciary duties).” These duties, in turn, “may be expanded or restricted or eliminated” in the agreement, provided that the “agreement may not eliminate the implied contractual covenant of good faith and fair dealing.”

The same issues and considerations that arise in limited partnerships arise in governance disputes in limited liability companies. There is an assumed default to traditional corporate governance fiduciary duties where the agreement is silent, or at least not inconsistent with the common law fiduciary duties. Lack of clarity in the agreements on this point may confuse the court and cause it to focus improperly when addressing the conduct complained of in a derivative action or in an action to interpret, apply, or enforce the terms of the limited liability company agreement. Predictably, but not necessarily correctly, Delaware courts will gravitate toward a focus on the parties’ status relationship and not their contractual relationship in the search for a legal and equitable resolution of a dispute unless the agreement explicitly compels the court to look to its terms and not to the common law fiduciary gloss.

See *supra* note 1225 and related text regarding Chief Justice Steele’s views in respect of fiduciary duties in the limited partnership context.

¹³⁵¹ *Id.* See RESTATEMENT (SECOND) OF CONTRACTS and related Comment which provide:

§ 205. Duty of Good Faith and Fair Dealing

Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.

Comment:

a. Meanings of “good faith.” Good faith is defined in Uniform Commercial Code § 1-201(19) as “honesty in fact in the conduct or transaction concerned.” “In the case of a merchant” Uniform Commercial Code § 2-103(1)(b) provides that good faith means “honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade.” The phrase “good faith” is used in a variety of contexts, and its meaning varies somewhat with the context. Good faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party; it excludes a variety of types of conduct characterized as involving “bad faith” because they violate community standards of decency, fairness or reasonableness. The appropriate remedy for a breach of the duty of good faith also varies with the circumstances.

b. Good faith purchase. In many situations a good faith purchaser of property for value can acquire better rights in the property than his transferor had. See, e.g., § 342. In this context “good faith” focuses on the honesty of the purchaser, as distinguished from his care or negligence. Particularly in the law of negotiable instruments inquiry may be limited to “good faith” under what has been called “the rule of the pure heart and the empty head.” When diligence or inquiry is a condition of the purchaser’s right, it is said that good faith is not enough. This focus on honesty is appropriate to cases of good faith purchase; it is less so in cases of good faith performance.

c. Good faith in negotiation. This Section, like Uniform Commercial Code § 1-203, does not deal with good faith in the formation of a contract. Bad faith in negotiation, although not within the scope of this Section, may be subject to sanctions. Particular forms of bad faith in bargaining are the subjects of rules as to capacity to contract, mutual assent and consideration and of rules as to invalidating causes such as fraud and duress. See, for example, §§ 90 and 208. Moreover, remedies for bad faith in the absence of agreement are found in the law of torts or restitution. For examples of a statutory duty to bargain in good faith, see, e.g., National Labor Relations Act § 8(d) and the federal Truth in Lending Act. In cases of negotiation for modification of an existing contractual relationship, the rule stated in this Section may overlap with more specific rules requiring negotiation in good faith. See §§ 73, 89; Uniform Commercial Code § 2-209 and Comment.

d. Good faith performance. Subterfuges and evasions violate the obligation of good faith in performance even though the actor believes his conduct to be justified. But the obligation goes further: bad faith may be overt or may consist of inaction, and fair dealing may require more than honesty. A complete catalogue of types of bad faith is impossible, but the following types are among those which have been recognized in judicial decisions: evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party’s performance.

e. Good faith in enforcement. The obligation of good faith and fair dealing extends to the assertion, settlement and litigation of contract claims and defenses. See, e.g., §§ 73, 89. The obligation is violated by dishonest conduct such as conjuring up a pretended dispute, asserting an interpretation contrary to one’s own understanding, or falsification of facts. It also extends to dealing which is candid but unfair, such as taking advantage of the necessitous circumstances of the other party to extort a modification of a contract for the sale of goods without legitimate commercial reason. See Uniform Commercial Code § 2-209, Comment 2. Other types of violation have been recognized in judicial decisions: harassing demands for assurances of performance, rejection of performance for unstated reasons, willful failure to mitigate damages, and abuse of a power to determine compliance or to terminate the contract. For a statutory duty of good faith in termination, see the federal Automobile Dealer’s Day in Court Act, 15 U.S.C. §§ 1221-25 (1976).

Except as expressly set forth in this Agreement or expressly required by the Delaware Act, no Manager or Member shall have any duties or liabilities, including fiduciary duties, to the Company or any Member, and the provisions of this Agreement, to the extent that they restrict, eliminate or otherwise modify the duties and liabilities, including fiduciary duties, of any Manager or Member otherwise existing at law or in equity, are agreed by the Company and the Members to replace such other duties and liabilities of the Managers and Members; provided that nothing here shall be construed to eliminate the implied contractual covenant of good faith and fair dealing under Delaware law.

Provisions such as the foregoing are often subject to intense negotiations and some investors may not agree to the limitations on duties and liabilities that those in control propose.

Provisions in Company Agreements purporting to limit fiduciary duties need to be explicit and conspicuous as LLC coyness can lead to unenforceability.¹³⁵² A provision which

In *Kuroda v. SPJS Holdings, L.L.C.*, 971 A.2d 872 (Del. Ch. April 15, 2009), a dispute among members of an LLC, the Chancellor dismissed plaintiff's allegations that the defendant members had breached the implied covenant of good faith and fair dealing by failing to pay him monies due, disparagements and threats because plaintiff had "failed to articulate a contractual benefit he was denied as a result of defendants' breach of an implied provision in the contract," and explained:

The implied covenant of good faith and fair dealing inheres in every contract and "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 bargain." The implied covenant cannot be invoked to override the express terms of the contract. Moreover, rather than constituting a free floating duty imposed on a contracting party, the implied covenant can only be used conservatively "to ensure the parties' 'reasonable expectations' are fulfilled." Thus, to state a claim for breach of the implied covenant, Kuroda "must allege a specific implied contractual obligation, a breach of that obligation by the defendant, and resulting damage to the plaintiff." General allegations of bad faith conduct are not sufficient. Rather, the plaintiff must allege a specific implied contractual obligation and allege how the violation of that obligation denied the plaintiff the fruits of the contract. Consistent with its narrow purpose, the implied covenant is only rarely invoked successfully.

This contractual duty of good faith and fair dealing is to be contrasted with the fiduciary duty of good faith, which is a component of the common law fiduciary duty of loyalty. *See Stone v. Ritter*, 911 A.2d 362 (Del. 2006). DLLCA §§ 18-1101(a)-(f) are counterparts of, and virtually identical to, §§ 17-1101(a)-(f) of the Delaware Revised Limited Partnership Act. *See DEL. CODE ANN. tit. 6, § 17-1101* (2009). Thus, Delaware cases regarding contractual limitation of partner fiduciary duties should be helpful in the LLC context.

¹³⁵² *Solar Cells, Inc. v. True N. Partners, LLC*, No. CIV.A.19477, 2002 WL 749163, at *4 (Del. Ch. Apr. 25, 2002). In *Solar Cells*, Chancellor Chandler enjoined the merger of an LLC with an affiliate of the controlling owner on the basis of the Delaware "entire fairness" doctrine notwithstanding an operating agreement section providing in relevant part as follows:

Solar Cells and [First Solar] acknowledge that the True North Managers have fiduciary obligations to both [First Solar] and to True North, which fiduciary obligations may, because of the ability of the True North Managers to control [First Solar] and its business, create a conflict of interest or a potential conflict of interest for the True North Managers. Both [First Solar] and Solar Cells hereby waive any such conflict of interest or potential

purports to limit fiduciary duties in the LLC context “to the maximum extent permitted by the laws in effect at the effective date of this Company Agreement, as such Agreement may be amended from time to time” probably is not adequate.

Persons who control Members can be held responsible for fiduciary duty breaches of the Members.¹³⁵³ A legal claim exists in some jurisdictions for aiding and abetting a breach of fiduciary duty, whether arising under statute, contract, common law or otherwise.¹³⁵⁴

conflict of interest and agree that neither True North nor any True North Manager shall have any liability to [First Solar] or to Solar Cells with respect to any such conflict of interest or potential conflict of interest, provided that the True North managers have acted in a manner which they believe in good faith to be in the best interest of [First Solar].

Chancellor Chandler noted that the above clause purports to limit liability stemming from any conflict of interest, but that Solar Cells had not requested that the Court impose liability on the individual defendants; rather it was only seeking to enjoin the proposed merger. Therefore, exculpation for personal liability would have no bearing on whether the proposed merger was inequitable and should be enjoined. Further, Chancellor Chandler wrote that “even if waiver of liability for engaging in conflicting interest transactions is contracted for, that does not mean that there is a waiver of all fiduciary duties [for the above quoted provision] expressly states that the True North Managers must act in ‘good faith.’”

Noting that the LLC was in financial distress and that the owners had been negotiating unsuccessfully to develop a mutually acceptable recapitalization, the Chancellor found that the managers appointed by the controlling owners appeared not to have acted in good faith when they had adopted the challenged plan of merger by written consent without notice to the minority managers. Chancellor Chandler commented:

The fact that the Operating Agreement permits action by written consent of a majority of the Managers and permits interested transactions free from personal liability does not give a fiduciary free reign to approve any transaction he sees fit regardless of the impact on those to whom he owes a fiduciary duty.

¹³⁵³

In *Bay Center Apartments Owner, LLC v. Emery Bay PKI, LLC*, C.A. No. 3658-VCS, 2009 WL 1124451 (Del. Ch. April 20, 2009), Delaware Vice Chancellor Strine wrote that “in the absence of a contrary provision in the LLC agreement, the manager of an LLC owes the traditional fiduciary duties of loyalty and care to the members of the LLC,” and held that LLC agreement provisions that “Members shall have the same duties and obligations to each other that members of a limited liability company formed under the Delaware Act have to each other” and “except for any duties imposed by this Agreement . . . each Member shall owe no duty of any kind towards the Company or the other Members in performing its duties and exercising its rights hereunder or otherwise” had the effect of leaving in place the traditional Delaware common law fiduciary duties. The Vice Chancellor then summarized those duties as follows in footnote 33:

The Delaware LLC Act is silent on what fiduciary duties members of an LLC owe each other, leaving the matter to be developed by the common law. The LLC cases have generally, in the absence of provisions in the LLC agreement explicitly disclaiming the applicability of default principles of fiduciary duty, treated LLC members as owing each other the traditional fiduciary duties that directors owe a corporation. Moreover, when addressing an LLC case and lacking authority interpreting the LLC Act, this court often looks for help by analogy to the law of limited partnerships. In the limited partnership context, it has been established that “[a]bsent a contrary provision in the partnership agreement, the general partner of a Delaware limited partnership owes the traditional fiduciary duties of loyalty and care to the Partnership and its partners.” (Citations omitted)

The court then held the owner and manager of the LLC personally liable for the fiduciary duty breaches of the LLC’s managing member.

In reviewing and analyzing the Delaware holdings in *Auriga* and *Gatz*, an article from Business Law Today published by the American Bar Association (the “*ABA Article*”) offers specific advice for drafters of LLC Agreements with respect to modifying the fiduciary duties which may now be implied by law.¹³⁵⁵ To dispense with the unpredictability of such implications, the ABA Article suggests specific provisions and strategies for three types of common LLC situations: (1) LLCs as private equity/hedge funds, (2) LLCs as joint ventures/multimember LLCs, and (3) LLCs in structured finance transactions, as discussed below.

(1) Private Equity/Hedge Funds. In LLC hedge or private equity funds, a Manager may owe fiduciary duties to the LLC fund and the investor Members; however, the Manager typically also manages other similarly situated funds, creating an inherent conflict of interest. Accordingly, the ABA Article recommends including unambiguous provisions modifying or eliminating fiduciary duties in the LLC agreement of such a fund to permit Managers to more effectively make decisions without the fear of a breach of fiduciary duty claim affecting each action. To do so, drafters could include a provision in the LLC agreement that explicitly eliminates all fiduciary duties for Managers and its affiliates, although a downside to such an “all or nothing” approach is that it may cause potential investors to question the loyalty of such conflicted Managers and balk. A next option would be to provide that default principles of fiduciary duties would not be applicable to certain actions of the Managers which would be subject to a “sole discretion” standard.¹³⁵⁶ Another option to curtail the application of default fiduciary duties would be to provide for advisory committee approval of Managers’ actions, invoking a review mechanic similar to that of a “special committee” in the corporate context.¹³⁵⁷ Finally, drafters could specifically authorize certain relationships or transactions they know to be potentially problematic but acceptable for the LLC in advance, notwithstanding any fiduciary duties that may exist. Calling out specific situations where fiduciary duty conflicts tend to arise may be particularly helpful where

See also In re USACafes, L.P. Litigation, 600 A.2d 43, 48 (Del. Ch. 1991); *Carson v. Lynch Multimedia Corp.*, 123 F. Supp. 2d 1254, 1264 (D. Kan. 2000).

¹³⁵⁴ *Fitzgerald v. Cantor*, No. CIV.A.16297-NC, 1999 WL 182573, at *1 (Del. Ch. Mar. 25, 1999) (holding that the elements of a claim for aiding and abetting a breach of fiduciary duty are: (1) the existence of a fiduciary relationship; (2) the fiduciary breached its duty; (3) a defendant, who is not a fiduciary, knowingly participated in a breach; and (4) damaged to the plaintiff resulted from the concerted action of the fiduciary and the non-fiduciary).

¹³⁵⁵ Paul Altman, Elisa Erlenbach Maas and Michael P. Maxwell, *Eliminating Fiduciary Duty Uncertainty: The Benefits of Effectively Modifying Fiduciary Duties in Delaware LLC Agreements*, Business Law Today, February 22, 2013, available at <http://apps.americanbar.org/buslaw/blt/content/2013/02/article-05-altman.shtml>.

¹³⁵⁶ Such a “sole discretion” standard should be well defined in a manner that precludes application of traditional fiduciary duties. *Id.*

¹³⁵⁷ If appropriately drafted, such a structure would permit Managers to contractually “cleanse” interested transactions and avoid becoming subject to the more strict entire fairness review. *Id.* Cf. *Allen v. Encore Energy Partners, L.P.*, 72 A.3d 93 (Del. 2013), *Norton v. K-Sea Transportation Partners L.P.*, 67 A.3d 354 (Del. 2013) and *Gerber v. Enter. Prods. Hldgs., LLC*, 67 A.3d 400 (Del. 2013), discussed *supra* in notes 1227-1237 and related text, regarding the use of such a committee in the context of a limited partnership.

broader modifications or the outright elimination of fiduciary duties are not feasible in a particular fund.¹³⁵⁸

(2) Joint Ventures; Multimember LLCs. Because of the many advantages of the LLC structure, more joint ventures, start-up companies, large and small businesses, and even large publicly held companies are being formed as LLCs. In these multimember LLC structures, there are a number of factors to consider in the fiduciary duty context, including the duration of any duties, Manager and non-Manager duties, duties amongst the LLC's Members, and potential conflicts of interest. In order to memorialize their desired level of fiduciary duty commitments, parties to a multimember LLC could seek to avoid the uncertainty of default duties and clearly delineate each person's obligations to the LLC and each other. For example, in the context of potential conflicts of interest, parties to a multimember LLC agreement could seek to avoid the application of the corporate opportunity doctrine by including specific provisions on what the business of the LLC will likely be, what it will seek to accomplish, and what (if any) opportunities the Members and Managers will be able to pursue without having to present them to the LLC first (or at all).¹³⁵⁹ Multimember LLCs could also seek to modify or eliminate fiduciary duties by contract in order to provide flexibility and certainty for Managers and Members making decisions in a management capacity for the LLC. In publicly traded LLCs with many Members, the number of potential plaintiffs in a fiduciary duty-gone-wrong claim can be magnified, and accordingly, a well-reasoned LLC agreement with appropriate advance fiduciary duty modifications is of paramount importance. The ABA Article points out that the means of effecting such modifications in the publicly traded LLC arena can vary – for example, an LLC Agreement could establish a “special approval” process for potential conflicted transactions such that a Manager of an LLC and its affiliates could rebut any claim for breach of fiduciary duty simply by following a proscribed approval process.¹³⁶⁰

(3) Structured Finance. Fiduciary duties can also be modified in structured finance transactions involving the use of an LLC established to own specific assets (“*SPEs*”). SPEs must follow specific guidelines, including having an individual with no relationship to the parent Member designated as an “independent Manager,” who must approve any material actions of the LLC. This relationship carries special fiduciary duty considerations. For example, in a bankruptcy situation, lenders and credit agencies will often require that the fiduciary duties in the SPE's LLC agreement be modified such that independent Manager must take into account the interest not only of the SPE and the SPE's parent Member, but also the SPE's creditors with respect to its interest in the SPE, when deciding to approve a material action.¹³⁶¹ Because the creditors of an SPE may be prejudiced by a voluntary bankruptcy filing of the SPE, an independent Manager who also owes fiduciary duties to the SPE's creditors can make the SPE more attractive to future debt investors.

¹³⁵⁸ *Altman et al., supra* note 1355.

¹³⁵⁹ *Id.*

¹³⁶⁰ *Id.*

¹³⁶¹ *Id.*

The alternatives discussed above are but a few in the evolving world of provisions that are emerging in LLC agreements in the light of the increasing likelihood that courts will imply certain fiduciary duties to Managers and Members of an LLC in the absence of contrary language in the LLC agreement. Drafters have the opportunity to consider and contract around thorny issues such as conflicts of interest, approval processes for material actions, and other highly-litigated matters in the LLC agreement rather than waiting for the courts to impose a potentially undesirable standard.

5.5. Business Combinations. Part Ten of LLC Act and Chapter 10 of the TBOC contain merger provisions that allow an LLC to merge with one or more LLCs or “other entities” (i.e. any corporation, limited partnership, general partnership, joint venture, joint stock company, cooperative, association, bank, insurance company or other legal entity) to the extent that the laws or constituent documents of the other entity permit the merger.¹³⁶² The merger must be pursuant to a written plan of merger containing certain provisions,¹³⁶³ and the entities involved must approve the merger by the vote required by their respective governing laws and organizational documents. Under Tex. LLC Stats., a merger is effective when the entities file an appropriate certificate of merger with the Secretary of State, unless the plan of merger provides for delayed effectiveness.¹³⁶⁴

An LLC’s merger with another entity must be approved by a majority of the LLC’s members, unless its certificate of formation or Company Agreement specifies otherwise.¹³⁶⁵ The Tex. LLC Stats. grant broad authority for who can execute merger documents on a company’s behalf.¹³⁶⁶ Their provisions on short form mergers are broadly drafted to allow their application to all types of entities that own, are owned by, or are under common ownership with a domestic limited liability company in the required percentage.¹³⁶⁷

The Tex. LLC Stats. also authorize an LLC to convert into another form of entity, or convert from another form of entity into an LLC, without going through a merger or transfer of assets, and has provisions relating to the mechanics of the adoption of a plan of conversion, owner approval, filings with the Secretary of State, and the protection of creditors.¹³⁶⁸

The Texas LLC Stats. allow the Company Agreement to provide whether, or to what extent, Member approval of sales of all or substantially all of the LLC’s assets is required.¹³⁶⁹ In

¹³⁶² However, the TBOC does impose restrictions on mergers involving nonprofit corporations. *See* TBOC § 10.010.

¹³⁶³ The LLC Act’s requirements appear in its § 10.02. The TBOC’s requirements are in its §§ 10.002 and 10.003.

¹³⁶⁴ LLC Act §§ 9.03, 10.03; TBOC § 10.007 and Revisor’s Note thereto.

¹³⁶⁵ LLC Act § 10.01A; TBOC §§ 10.001, 10.1356, 10.1052. Under TBOC § 10.1354 “majority” is determined on a per capita basis (i.e., one Member, one vote) unless the Company Agreement provides otherwise.

¹³⁶⁶ LLC Act § 10.03A; TBOC §§ 10.001(b), 10.151(b).

¹³⁶⁷ *See* LLC Act § 10.05; TBOC § 10.006.

¹³⁶⁸ LLC Act §§ 10.08-10.09; TBOC §§ 10.101-10.105. Note, the TBOC permits LLCs still governed by the LLC Act to convert into another entity form to be governed by the TBOC. TBOC § 10.102.

¹³⁶⁹ *See supra* notes 88-89 and related text regarding the requirements of TBCA arts. 5.09 and 5.10 and the parallel TBOC provisions.

the absence of a Company Agreement provision, the default under the TBOC is to require Member approval for the sale of all or substantially all of the assets of an LLC.¹³⁷⁰

5.6. Indemnification. Under the Tex. LLC Stats., an LLC may indemnify any of its Members, Managers, officers or other persons subject only to such standards and restrictions, if any, as may be set forth in the LLC’s certificate of formation or Company Agreement.¹³⁷¹ The restrictions on indemnification applicable to for-profit corporations are not applicable to LLCs.¹³⁷² This approach is similar to the approach taken under Delaware law, but could be subject to public policy limitations.¹³⁷³ In any event, this change increases the importance of having long form indemnification because a “to maximum extent permitted by law” provision may encompass things neither the drafter nor the client foresaw, which could lead courts to read in public policy limits or find the provision void for vagueness. The indemnification provisions should specify who is entitled to be indemnified for what and under what circumstances, which requires both thought and careful drafting.

5.7. Capital Contributions. The contribution of a Member may consist of any tangible or intangible benefit to the LLC or other property of any kind or nature, including a promissory note, services performed, a contract for services to be performed or other interests in or securities or other obligations of any other LLC or other entity.¹³⁷⁴ The Company Agreement ordinarily would contain provisions relative to when and under what circumstances capital contributions are required,¹³⁷⁵ capital accounts and the allocation of profits and losses comparable to those in a limited partnership agreement.

¹³⁷⁰ TBOC § 1.002(32) defines “fundamental business transaction” to include a “sale of all or substantially all of the entity’s assets” and TBOC § 101.356 requires a member vote to approve any fundamental business transaction, although TBOC § 101.052 would allow the parties to include in the Company Agreement provisions that trump this TBOC requirement.

¹³⁷¹ LLC Act § 2.20A; TBOC § 101.402.

¹³⁷² See generally Chapter 8 of the TBOC, specifically § 8.002(a).

¹³⁷³ Cf. DEL. CODE ANN. tit. 6, § 18-108 (1999 & Supp. 2002) (providing that an LLC may, and shall have the power to, indemnify and hold harmless Members, Managers, and other persons from and against any and all claims).

¹³⁷⁴ LLC Act § 5.01; TBOC § 1.002(9). LLC Act § 5.02 and TBOC §§ 101.052 and 101.151 provide that written obligations to make contributions are enforceable, except to the extent otherwise provided in the Articles or Regulations (or Certificate of Formation or Company Agreement, as appropriate), and LLC Act § 4.07 and TBOC § 101.111(b) provide that an obligation to make a contribution will survive the assignment of the membership interest. LLC Act § 5.02 and TBOC § 101.156 provide that a conditional obligation to make a contribution to an LLC, which includes contributions payable upon a discretionary call prior to the time the call occurs, must be in writing and signed by the Member, and may not be enforced unless the conditions of the obligation have been satisfied or waived.

¹³⁷⁵ In Elizabeth S. Miller, *Practical Pitfalls in Drafting Texas Limited Liability Company Agreements*, 45:1 TEX. J. BUS. L. 27, 46 (2012), the author discusses issues with Company Agreement provisions relating to capital contributions:

Provisions that require future capital contributions or permit capital calls should be carefully considered. The BOC provides for non-liability of the members to LLC creditors for the LLC’s obligations, but there are nevertheless certain situations in which a member may be held liable to the LLC in an action by an LLC creditor. A creditor of an LLC may enforce a member’s obligation to make a contribution to the LLC even though it has been released by the LLC if the creditor extended credit or otherwise reasonably

relied on the obligation after the member signed a writing reflecting the obligation and before the writing was amended or cancelled to reflect the release. * * *

Sometimes it may be desirable for the company agreement to grant manager(s) or managing member(s) the right to call for contributions when they conclude the LLC needs additional cash. These “cash call” or “capital call” provisions ordinarily do not give creditors any rights unless the call has already been made because a creditor may not enforce a conditional obligation to make a contribution unless the conditions or obligations have been satisfied or waived. Conditional obligations include contributions payable upon a discretionary call of the LLC before the call occurs. Nevertheless, these provisions should be carefully drafted to avoid any implication that the members have agreed to waive their limited liability. Additionally, even if creditors cannot invoke a discretionary capital call provision, the members should consider carefully the extent to which they want to expose themselves to this type of obligation, at whose discretion, and with what consequences in the event of a failure to contribute.

* * *

Generally, even in a manager-managed LLC whose certificate of formation does not identify the initial members, the identities of one or more initial members will be understood at the time an LLC is formed, and it is prudent for the initial members to execute a written company agreement prior to or contemporaneously with the filing of the certificate of formation so that it is clear who the members are and what their economic and governance rights are. The BOC expressly recognizes, however, the formation of an LLC that does not initially have any members, sometimes referred to as a “shelf” LLC. Under this provision, an organizer may file a certificate of formation that identifies one or more initial managers, but the LLC need not have any members for a “reasonable period” after the LLC is formed.

While it is possible to utilize a “shelf” LLC, there are some questions associated with such a practice. First, what is a “reasonable period” after the filing of the certificate of formation? Is it merely a temporal concept or does it also relate to the activities undertaken by the LLC? Presumably, the managers may undertake certain actions to facilitate the organization of the LLC and securing of investors, but it would be unwise to transact significant business prior to the admission of members. What is the tax classification of an LLC without members? If the LLC undertakes any significant business and there is a failure to obtain members or a dispute as to whether there are members and who they are, this could be a thorny situation.

At the point that there are persons who desire to be members in an LLC that has previously been formed but has no members, may they simply execute a company agreement identifying themselves as the members and thereby become members “in connection with the formation” of the LLC? It would appear so, but what if there is a dispute as to who the members will be, i.e., a fight over the LLC? If two factions each execute a company agreement claiming to be the members, who determines which is the company agreement of the LLC? Inasmuch as becoming a member “in connection with the formation of the LLC” when one is not named as an initial member in the certificate of formation depends upon a reflection of the person’s membership in an LLC “record,” it appears that the manager or managers may have a role in determining which company agreement is the company “record” of membership.

If, after the filing of the certificate of formation of an LLC, a substantial period of time elapses without the admission of members, the question might arise whether a person who desires to become a member must do so in accordance with the statutory procedures applicable “after the formation” of the LLC. This result would be problematic because the statute requires that a person becoming a member after formation of the LLC must do so with the consent of all members unless a company agreement provides otherwise. It would be impossible to admit a member under such circumstances because the LLC has no members and thus no company agreement. It is more logical to interpret

5.8. Allocation of Profits and Losses; Distributions. Allocations of profits and losses, and distributions of cash or other assets, of an LLC are made to the Members in the manner provided by the Company Agreement.¹³⁷⁶ If the Company Agreement does not otherwise provide, allocations and distributions are made on the basis of the agreed value of the contributions made by each Member.¹³⁷⁷ A Member is not entitled to receive distributions from an LLC prior to its winding up unless specified in the Company Agreement if the LLC is governed by the TBOC.¹³⁷⁸ An LLC may not make a distribution to its Members to the extent that, immediately after giving effect to the distribution, all liabilities of the LLC, other than liabilities to Members with respect to their interests and non-recourse liabilities, exceed the fair value of the LLC assets.¹³⁷⁹ A Member who receives a distribution that is not permitted under the preceding sentence has no liability to return the distribution under the Tex. LLC Stats. unless the Member knew that the distribution was prohibited.¹³⁸⁰ The limitations on distributions by an LLC do not apply to payments for reasonable compensation for past or present services or reasonable payments made in the ordinary course of business under a bona fide retirement or other benefits program.¹³⁸¹

5.9. Owner Liability Issues. The Tex. LLC Stats. provide that, except as provided in the Company Agreement, a Member or Manager is not liable to third parties for the debts, obligations or liabilities of an LLC, although Members are liable for the amount of any contributions they agreed in writing to make.¹³⁸² Members may participate in the management

the statute as permitting persons to become members “in connection with the formation” of the LLC if the LLC has previously existed as a memberless shell entity, even if a substantial period of time has passed since the filing of the certificate of formation.

¹³⁷⁶ LLC Act §§ 5.02-1, 5.03; TBOC §§ 101.052, 101.201. A new Subchapter M was added to TBOC Chapter 101 in the 2009 Legislative Session by 2009 S.B. 1442 § 45 to permit LLCs to establish series of members, managers, membership interests or assets to which different assets and liabilities may be allocated. Through appropriate provisions in the Company Agreement and Certificate of Formation, the assets of one series could be isolated from the liabilities attributable to a different series.

¹³⁷⁷ LLC Act §§ 5.02-1, 5.03; TBOC §§ 101.052, 101.201.

¹³⁷⁸ TBOC § 101.204 provides this as a new default rule, subject to contrary agreement under § 101.052. The older LLC Act, however, simply provides that Members are entitled to pre-winding up distributions in accordance with the Articles of Incorporation. LLC Act § 5.04.

¹³⁷⁹ LLC Act § 5.09A; TBOC § 101.206.

¹³⁸⁰ LLC Act § 5.09B; TBOC § 101.206(d); *see Weinstein v. Colborne Foodbotics, LLC*, 302 P.3d 263 (Co. 2013), the Colorado Supreme Court held that (i) an insolvent LLC’s members are not liable to the creditors of the LLC for an unlawful distribution although the LLC’s members are liable to the LLC for the same, and (ii) an insolvent LLC’s managers do not owe an LLC’s creditors the same common law fiduciary duty that an insolvent corporation’s directors might owe the corporation’s creditors.

¹³⁸¹ TBOC § 101.206(f) as amended in 2009 Legislative Session by 2009 S.B. 1442 § 41.

¹³⁸² LLC Act §§ 4.03, 5.02A; TBOC §§ 101.114; 101.151. LLC Act Art. 4.03 provided as follows:

Art. 4.03. LIABILITY TO THIRD PARTIES. A. Except as and to the extent the regulations specifically provide otherwise, a member or manager is not liable for the debts, obligations or liabilities of a limited liability company including under a judgment, decree, or order of a court.

B. Transaction of business outside state. It is the intention of the legislature by the enactment of this Act that the legal existence of limited liability companies formed under this Act be recognized beyond the limits of this state and that, subject to any reasonable registration requirements, any such limited liability company transacting business outside this state be granted the protection of full faith and credit under Section 1 of Article IV of the Constitution of the United States.

of the LLC without forfeiting this liability shield,¹³⁸³ but may be liable for their own torts.¹³⁸⁴ Since the Tex. LLC Stats. deal expressly with the liability of Members and Managers for LLC

C. Parties to actions. A member of a limited liability company is not a proper party to proceedings by or against a limited liability company, except where the object is to enforce a member's right against or liability to the limited liability company.

(emphasis added)

TBOC § 101.114 provides for substantially the same protection of Members and Managers as LLC Act § 4.03A. *See infra* notes 1558-1585 and related text regarding uncertainties as to the extent to which this statutory limitation of liability will be recognized in other states.

The legislative history of the LLC Act mirrors the clear statutory statement that members and managers of an LLC are not to be personally liable for the obligations of the LLC (whether arising in tort or contract) by virtue of being a member or manager:

Article 4.03. Liability to Third Parties. This Article provides except as provided in the regulations, that a member or manager is not liable to third parties, expresses the legislative intent that limited liability be recognized in other jurisdictions and states a member is not a proper party to a proceeding by or against a Limited Liability Company.

(emphasis added)

The clear and unequivocal limitation of personal liability wording of LLC Act § 4.03A is to be contrasted with the more complicated and narrow wording of TBCA art. 2.21, which evolved as the Legislature attempted to drive a stake through the heart of *Castleberry v. Branscum*, 721 S.W.2d 270 (Tex. 1986) and its progeny. If the Bar Committee or the Legislature had conceived that the case law which had evolved in the corporate context would be applicable to LLCs, the wording of the LLC Act would have been different and might have mirrored that of the TBCA (which was already in place when the LLC Act was drafted). Intending that corporate veil piercing principles not be applicable to LLCs, and to prevent LLCs from being infected with the principles of *Castleberry v. Branscum*, which were considered inappropriate for LLCs, the Bar Committee and the Legislature opted for a simple, expansive and unequivocal statement that members and managers of LLCs do not have liability for any LLC obligations.

¹³⁸³ The LLC Act does not contain any provision comparable to TRLPA § 3.03 or TBOC § 153.102, which make a limited partner liable for partnership obligations under certain circumstances if “the limited partner participates in the control of the business.”

¹³⁸⁴ Even though corporate veil piercing theories should not be applicable to Texas LLCs, parties dealing with an LLC are not without remedies against those responsible for the actions of the entity in appropriate situations. In contract situations, persons dealing with an LLC can condition their doing business with the LLC on (i) an LLC including in its Regulations or Operating Agreement provisions for the personal liability of Members or Managers in specified circumstances or (ii) Members or Managers personally guaranteeing obligations of the LLC. In the tort context, a Member or Manager individually may be a direct tortfeasor and liable under traditional tort law theories for his own conduct. *See Walker v. Anderson*, 232 S.W.3d 899 (Tex. App.—Dallas 2007, no pet.); *Shapolsky v. Brewton*, 56 S.W.3d 120, 133 (Tex. App.—Houston [14th Dist.] 2001, pet. denied); *Weber v. U.S. Sterling Sec., Inc.*, 924 A.2d 816 (Conn. 2007) (holding that liability protection of managers and members under the Delaware LLC statute does not protect members or managers from direct liability for their own torts). In addition, Texas and federal fraudulent transfer laws provide protection to entity creditors where insiders have improperly transacted business with an entity which is insolvent or would be rendered insolvent thereby. *See* 11 U.S.C. §548 (2008); TEX. BUS. & COM. CODE ANN. §§24.001-013 (Vernon 2011); Byron F. Egan, *Acquisition Structure Decision Tree*, 150–153, prepared for the TexasBarCLE & Business Law Section of State Bar of Texas Choice and Acquisition of Entities in Texas Course on May 25, 2012, and available at: <http://images.jw.com/com/publications/1736.pdf>.

obligations, the principles of “piercing the corporate veil” should not apply to LLCs in Texas, although this issue is not settled.¹³⁸⁵

¹³⁸⁵

Despite the clear legislative intent to the contrary, some lower court opinions in Texas have suggested that veil-piercing concepts from corporation law are applicable to LLCs. But they have done so only in narrow circumstances, have acknowledged that a mere absence of corporate formalities is not sufficient to support veil piercing, and have consistently recognized the applicability of TBCA art. 2.21 to LLC veil-piercing cases. See Elizabeth S. Miller, *Are There Limits on Limited Liability? Owner Liability Protection and Piercing the Veil of Texas Business Entities*, 43 TEX. J. OF BUS. L. 405, 416-426 (Fall 2009); Val Ricks, *The Twisted Veil of Texas LLCs*, 46 Tex. J. Bus. L. 67 (Fall 2014).

In *Pinebrook Props., Ltd. v. Brookhaven Lake Prop. Owners Ass’n*, 77 S.W.3d 487, 500 (Tex. App.—Texarkana 2002, pet. denied), a complicated real estate use and maintenance case, the Texarkana Court of Appeals assumed that corporate veil piercing rules must be applicable to an LLC because the LLC is a limited liability entity. The court cited *Castleberry*, even though *Castleberry* was decided five years before the enactment of the LLC Act, made no reference to the LLC (or any entity other than a business corporation) and had been repudiated by the Legislature in amendments to TBCA art. 2.21A. The Texarkana court did conclude that failure to comply with corporate formalities is no longer a relevant factor in the veil-piercing context and cited TBCA art. 2.21 as the relevant governing authority.

McCarthy v. Wani Venture, A.S., 251 S.W.3d 573 (Tex. App.—Houston [1st Dist] 2007, no pet.) held that corporate veil piercing principles apply to Texas LLCs notwithstanding the wording of LLC Act § 4.03(a) that “[e]xcept and to the extent the regulations specifically provide otherwise, a member or manager is not liable for the debts, obligations or liabilities of a limited liability company, including under a judgment, decree, or order of a court.” The court in *McCarthy* acknowledged that the LLC Act does not address whether the “corporate veil” of a LLC may be pierced, but cited *Pinebrook* and several cases from other jurisdictions to support its conclusion that veil piercing principles are applicable to LLCs under the LLC Act. *Id.* at 590. The court failed to incorporate into its analysis the clear legislative intent embodied in LLC Act § 4.03—namely, that the corporate veil piercing principles should not be applicable to LLCs and that LLCs were intended to be free from the uncertainties created by *Castleberry*. Nonetheless, *McCarthy* still recognizes that actual fraud is necessary to pierce the veil of an LLC, and that TBCA art. 2.21 is still the applicable standard. The jury instructions in *McCarthy* required that, in order to hold the defendant shareholders directly liable, the jury would have to find that defendants caused the LLC “to be used to perpetrate a fraud and did perpetrate an actual fraud . . . primarily for [their] own personal benefit.” In fact, no Texas court has ever applied corporate veil piercing principles to an LLC without also applying the restrictions of TBCA art. 2.21.

In a non-Texas case, *Taurus IP, LLC v. DaimlerChrysler Corp.*, 534 F.Supp. 2d 849 (W.D. Wis. 2008), the court, relying on *Castleberry*, held the non-owner Manager of a Texas LLC individually liable by employing a novel interpretation of TBCA art. 2.21. According to the *Taurus* court, TBCA art. 2.21 “limits alter ego liability only for shareholders, owners, subscribers and affiliates, not directors, officers, managers or members.” *Id.* at 871. The court eventually sidesteps the limits of TBCA art. 2.21 by asserting that the non-owner manager was never a shareholder or owner of the LLC, simply a Manager. In declaring this statutory exemption to veil-piercing liability inapplicable to Managers, the court ignores the fact that veil-piercing liability itself is inapplicable to Managers (much as it is inapplicable to officers and directors), and engages in an alter ego analysis that is entirely defective. But more problematic than the *Taurus* court’s apparent application of veil piercing to non-owner Managers is the court’s belief that because “Members” were not specifically included in the protections of TBCA art. 2.21, it was the Texas Legislature’s intent to give Members of an LLC even *less* protection from individual liability than shareholders of a Texas corporation. This is simply not the case. As discussed above, Members were not mentioned in TBCA art. 2.21 because it was never envisioned by the Legislature or the Bar Committee that veil piercing would be applied to Members of an LLC; had this been anticipated, LLC Act § 4.03 would have been drafted to mirror TBCA art. 2.21. (This also explains the absence of a reference to TBCA art. 2.21 in LLC Act § 8.12, which incorporates a few technical sections of the TBCA into the LLC Act: No reference was included because it was believed that veil-piercing would not be applied to LLCs.)

The Tex. LLC Stats. do not generally incorporate general corporate law or principles for situations not addressed in the Tex. LLC Stats. See LLC Act § 8.12 (Applicability of Other Statutes) for reference to the

few provisions of the TBCA and the TMCLA which apply to LLCs. None of those provisions relates to piercing the corporate veil. The provisions referenced in LLC Act § 8.12 were expressly incorporated into the TBOC, but still without reference to piercing the corporate veil.

Although not the intent of the Legislature and inconsistent with the clear wording of LLC Act § 4.03A, it is at least understandable that some courts would apply veil piercing to Texas LLCs. But to apply this corporate law theory to LLCs without also applying the limitations of TBCA art. 2.21 is inconsistent—not only with the express intent of the Bar Committee and the Legislature—but with the holdings of every single Texas court that has addressed the issue. The Texas Supreme Court’s decision in *SSP* (*see supra* note 240 and related text) makes this even clearer: by extending TBCA art. 2.21 to cases grounded purely in tort law, the Texas Supreme Court has acknowledged the Legislature’s intent that TBCA art. 2.21 be the law of the land.

Texas has its own body of precedent in the corporate context with respect to piercing the corporate veil, and if the Texas Supreme Court were to determine to look to corporate precedent in determining whether to respect the limitation of liability provided by the LLC Act, the Texas court would not necessarily consider the same factors as the courts in the reported cases from other jurisdictions. In *Gearhart Industries, Inc. v. Smith International*, 741 F.2d 707, 719 n.4 (5th Cir. 1984), the Fifth Circuit sharply criticized the parties’ failure to cite Texas jurisprudence:

We are both surprised and inconvenienced by the circumstances that, despite their multitudinous and voluminous briefs and exhibits, neither plaintiffs nor defendants seriously attempt to analyze officers’ and directors’ fiduciary duties or the business judgment rule under *Texas* law. This is a particularity so in view of the authorities cited in their discussions of the business judgment rule: Smith and Gearhart argue back and forth over the applicability of the plethora of out-of-state cases they cite, yet they ignore the fact that we are obligated to decide these aspects of this case under Texas law.

If the Texas Supreme Court were to sanction veil piercing concepts to hold Members or Managers of an LLC liable for LLC obligations, the Supreme Court should also apply the public policy inherent in TBCA art. 2.21 and make actual fraud a requirement for veil piercing.

There have been a number of cases in other jurisdictions in which courts have applied corporate veil piercing theories to LLCs. *See, e.g., N. Tankers (Cyprus) Ltd. v. Backstrom*, 967 F. Supp. 1391, 1402 (D. Conn. 1997); *Hollowell v. Orleans Reg’l. Hosp.*, No. CIV.A.95-4029, 1998 WL 283298, at *9 (E.D. La. May 29, 1998); *In re Multimedia Communications Group Wireless Assoc.*, 212 B.R. 1006 (Bankr. M.D. Fla. 1997); *Marina, LLC v. Burton*, No. CA 97-1013, 1998 WL 240364, at *7 (Ark. App. May 6, 1998); *Ditty v. CheckRite, Ltd.*, 973 F. Supp. 1320, 1336 (D. Utah 1997). In *Ditty*, a case examining a Utah limitation of Member liability statute similar to LLC Act § 4.03, the court wrote: “While there is little case law discussing veil piercing theories outside the corporate context, most commentators assume that the doctrine applies to limited liability companies.” *Ditty*, 973 F. Supp. at 1336. The court then proceeded to uphold the limited liability of the sole Member, officer and director for the LLC, noting that the fact that defendant “played an active role in the firm’s business is, at best, only marginally probative of the factors considered when determining whether to pierce the corporate veil.” *Id.* In the court’s view, the significant factors in determining whether to pierce the entity are “undercapitalization of a close corporation; failure to observe corporate formalities; siphoning of corporate funds by the dominant shareholder; nonfunctioning of other officers and directors; and the use of the corporation as a facade for operations of the dominant shareholder.” *Id.*

Texas has its own body of precedent in the corporate context with respect to piercing the corporate veil and, if a Texas court were to determine to look to corporate precedent in determining whether to respect the limitation of liability provided by the LLC Act, would not necessarily consider the same factors as the courts in the reported cases from other jurisdictions. In *Shook v. Walden*, 368 S.W.3d 604 (Tex. App.—Austin 2012, pet. denied), a Texas Court of Appeals discussed the history of TBCA Art. 2.21 and the application of veil piercing principles to LLCs prior to the recent addition of TBOC § 101.002 in 2011, and concluded that the actual fraud standard should apply as a matter of common law to LLC veil piercing cases pre-dating the 2011 amendment to TBOC § 101.002. The majority opinion in *Shook* acknowledges the *Taurus* case discussed above (where federal court in Wisconsin applying Texas law concluded that *Castleberry* standard applied to LLC since LLC not corporation governed by TBCA Art. 2.21), but reaches a different conclusion and cites the Bill Analysis of 2011 S.B. 323 discussed *infra*, which the dissenting justice argued should have made the *Castleberry* standards apply to LLCs prior to the September 1, 2011 effectiveness of

While TBOC § 101.114 (Liability for Obligations), like its source LLC Act § 4.03, provides that a member or manager is not liable for the debts, obligations or liabilities of an LLC, except as and to the extent the company agreement or regulations specifically provide otherwise and thus prohibits a court from holding the members or managers liable for the debts, obligations and liabilities of an LLC, some judicial opinions have failed to follow this express statutory mandate and have applied corporate veil piercing principles to LLCs, causing uncertainty as to the proper standards to be applied if LLC veil piercing is to be recognized. Some Texas opinions have applied corporate veil piercing standards in disregarding the statutory liability shield.¹³⁸⁶ When applying corporate veil piercing standards to LLCs, these courts recognized that the provisions of TBCA Article 2.21 (Liability of Subscribers and Shareholders), which are carried over in TBOC §§ 21.223 (Liability for Obligations) through 21.226 (Liability for Obligations), were controlling with respect to such standards.

In 2011 the TBOC was amended¹³⁸⁷ to clarify the standards for the piercing of the LLC statutory liability shield, if LLC veil piercing is determined to be available notwithstanding the express no personal liability provisions of TBOC § 101.114 (Liability for Obligations), by adding a new TBOC § 101.002 (Applicability of Other Laws) which provides that TBOC §§ 21.223 (Liability for Obligations), 21.224 (Preemption of Liability), 21.225 (Exceptions to Limitations) and 21.226 (Liability for Obligations) in respect of for-profit corporations apply to an LLC and its members, owners, assignees and subscribers, subject to the limitations contained in TBOC § 101.114 (Liability for Obligations). TBOC § 101.002, as amended in 2011, provides as follows:

Sec. 101.002. APPLICABILITY OF OTHER LAWS. (a) Subject to Section 101.114, Sections 21.223, 21.224, 21.225, and 21.226 apply to a limited liability company and the company's members, owners, assignees, affiliates, and subscribers.

(b) For purposes of the application of Subsection (a):

(1) a reference to "shares" includes "membership interests";

(2) a reference to "holder," "owner," or "shareholder" includes a "member" and an "assignee";

(3) a reference to "corporation" or "corporate" includes a "limited liability company";

TBOC § 101.002. *See generally* Elizabeth S. Miller, *Cases Involving Limited Liability Companies and Registered Limited Liability Partnerships*, PUBOGRAM, A.B.A. SEC. OF BUS. L. COMMITTEE ON PARTNERSHIPS AND UNINCORPORATED BUS. ORG., Vol. XXIV, No. 3, at 19; Ribstein, *The Emergence of the Limited Liability Company*, 51 BUS. LAW. 1, 8-9 (Nov. 1995).

¹³⁸⁶ *See, e.g., Shook v. Walden*, 368 S.W.3d 604 (Tex. App.—Austin, pet. denied); *McCarthy v. Wani Venture, A.S.*, 251 S.W.3d 573, (Tex. App.—Houston [1st Dist.] 2007, pet. denied); *In re JNS Aviation, LLC (Nick Corp. v. JNS Aviation, Inc.)*, 376 B.R. 500 (Bankr. N.D. Tex. 2007, amended in part by 2008 WL 686159 (Bankr. N.D. Tex. 2008)).

¹³⁸⁷ *See* S.B. 323 enacted in the 2011 Legislative Session.

(4) a reference to “directors” includes “managers” of a manager-managed limited liability company and “members” of a member-managed limited liability company;

(5) a reference to “bylaws” includes “company agreement”; and

(6) the reference to “Sections 21.157-21.162” in Section 21.223(a)(1) refers to the provisions of Subchapter D of this chapter.

If there was any uncertainty prior to the 2011 amendments to the TBOC, it should now be clear that the LLC liability shield is to be respected even if the LLC has only one member or is a disregarded entity for federal income tax purposes.¹³⁸⁸

Alter ego veil piercing principles similar to those applicable to Delaware corporations are applicable to Delaware LLCs, with the plaintiff having to demonstrate a misuse of the LLC form along with an overall element of injustice or unfairness.¹³⁸⁹ Some state LLC statutes expressly deal with the veil piercing issue by providing that the LLC veil will be pierced to the same extent as the corporate veil¹³⁹⁰ or that the Members will have the same liabilities as corporate shareholders.¹³⁹¹

5.10. Nature and Classes of Membership Interests. A membership interest in an LLC is personal property.¹³⁹² It does not confer upon the Member any interest in specific LLC property.¹³⁹³ A membership interest may be evidenced by a certificate if the Company Agreement so provides.¹³⁹⁴

The Company Agreement may establish classes of Members having expressed relative rights, powers and duties, including voting rights,¹³⁹⁵ and may establish requirements regarding the voting procedures and requirements for any actions including the election of Managers and amendment of the Certificate of Formation and Company Agreement.¹³⁹⁶ The Company Agreement could provide for different classes of Members, each authorized to elect a specified

¹³⁸⁸ See *supra* notes 238-242 and 1382-1388 and related text; *cf. Singh v. Duane Morris, L.L.P.*, 338 S.W.3d 176, 182 (Tex. App.—Houston [14th Dist.] 2011) (the fact that a corporation is an IRC Subchapter S-corporation with a single shareholder who is taxed on its earnings does not alter the bedrock principle of Texas law that an individual can incorporate a business and thereby normally shield himself from personal liability for the corporation’s obligations).

¹³⁸⁹ *NetJets Aviation, Inc. v. LHC Commc’ns, LLC*, 537 F.3d 168, 176 (2d Cir. 2008); *Heritage Org., LLC*, No. 04-35574-BJH-11, 2008 WL 5215688 (Bankr. N.D. Tex. Dec. 12, 2008).

¹³⁹⁰ See COLO. REV. STAT. 7-80-107 (1998); MINN. STAT. ANN. 322B.303.2 (1995 & Supp. 1998); WASH. REV. CODE ANN. § 25.15.060 (West Supp. 2003).

¹³⁹¹ See W. VA. CODE § 31-B-3-303(b) (2003).

¹³⁹² LLC Act § 4.04; TBOC § 101.106.

¹³⁹³ LLC Act § 4.04; TBOC § 101.106.

¹³⁹⁴ LLC Act § 4.05B; TBOC § 3.201(e).

¹³⁹⁵ Under TBOC § 101.354 Members vote on a per capita basis (i.e., one Member, one vote) unless the Company Agreement otherwise provides.

¹³⁹⁶ LLC Act § 4.02; TBOC § 101.104.

number or percentage of the Managers.¹³⁹⁷ The Tex. LLC Stats. generally allow even more flexibility in structuring classes of Members than is available under Texas law in structuring classes of corporate stock.¹³⁹⁸

Whether an LLC membership interest is considered a “security” for the purposes of the Securities Act of 1933, as amended, and state securities or blue sky laws turns on the rights of the Members as set forth in the Company Agreement and other governing documents and the ability of the investor to exercise meaningful control over his investment.¹³⁹⁹ The offer and sale

¹³⁹⁷ See LLC Act § 2.13; TBOC § 101.104.

¹³⁹⁸ See 1993 LLC Bill Analysis at 2; see also TBOC §§ 21.152, 101.104.

¹³⁹⁹ The Securities Act of 1933, 15 U.S.C.A. 77a, et seq. (1997) (the “1933 Act”), in § 77b(a)(1) defines the term “security” to include:

any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security,” or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

As a result of judicial construction of the term “investment contract” this definition now encompasses most long-term means for raising funds. See Carl W. Schneider, *The Elusive Definitions of a “Security”*, 14 REV. SEC. REG. 981, 981 (1981); Carl W. Schneider, *Developments in Defining a “Security”*, 16 REV. SEC. REG. 985 (1983). The United States Supreme Court has held that the test for determining whether an “investment contract” exists is “whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others.” *SEC v. W. J. Howey Co.*, 328 U.S. 293, 301 (1946); ; see *Robinson v. Glynn*, 349 F.3d 166 (4th Cir. 2003). In *Robinson*, the Fourth Circuit wrote:

Since *Howey*, however, the Supreme Court has endorsed relaxation of the requirement that an investor rely only on others’ efforts, by omitting the word “solely” from its restatements of the *Howey* test. And neither our court nor our sister circuits have required that an investor like *Robinson* expect profits “solely” from the efforts of others. Requiring investors to rely wholly on the efforts of others would exclude from the protection of the securities laws any agreement that involved even slight efforts from investors themselves. It would also exclude any agreement that offered investors control in theory, but denied it to them in fact. Agreements do not annul the securities laws by retaining nominal powers for investors unable to exercise them.

What matters more than the form of an investment scheme is the “economic reality” that it represents. The question is whether an investor, as a result of the investment agreement itself or the factual circumstances that surround it, is left unable to exercise meaningful control over his investment. Elevating substance over form in this way ensures that the term “investment contract” embodies “a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits.”

Id. at 170. By analogy to corporate stock and investment contracts, a membership interest in an LLC which is governed by Managers is most likely to be considered to be a security. By analogy to interests in a general

of an interest must either be registered under applicable federal and state securities laws¹⁴⁰⁰ or effected in a private¹⁴⁰¹ or other transaction structured to be exempt from those requirements.¹⁴⁰²

partnership, however, where the LLC is managed by its Members, the membership interest may not be deemed a security:

A general partnership interest normally is not a security, even if the investor elects to remain passive. But a general partnership interest may be a security if the rights of a partner are very limited in substance, or if the partner is an unsophisticated investor who must rely in fact on the business acumen of some other person.

A limited partnership interest normally is a security. On unusual facts, however, a limited partnership might not be a security -- e.g., where there is a single limited partner who negotiates directly with the general partner and retains significant influence over the venture, or where the limited partner otherwise has an active role in the venture.

Carl W. Schneider, *The Elusive Definition of a 'Security' – 1990 Update*, 24 REV. SEC. & COM. REG. 13, 22 (Jan. 23, 1991); see also Marc I. Steinberg & Karen L. Conway, *The Limited Liability Company As A Security*, 19 PEPP. L. REV. 1105 (1992). Steinberg and Conway concluded that:

While each LLC interest must be analyzed by looking at the applicable statutes as well as the specific provisions contained in the member agreement and other operating documents, this article takes the position that LLC interests normally are securities. Three different methods of analysis lead to this result. First, one may look at the traditional “investment contract” test and find that LLC interests satisfy the *Howey* test, especially in light of the *Williamson* rationale. Second, LLC interests meet the attributes of stock test as set forth by the Supreme Court. Finally, one can classify an interest in a LLC as “any interest commonly known as a security.

Id. at 1122. See also *SEC v. Parkersburg Wireless, LLC*, 991 F.Supp. 6, 8 (D.D.C. 1997) (holding that interests in an LLC with 700 Members were investment contracts); *SEC v. Vision Communications, Inc.*, CIV. No. 94-0615, 1994 WL 855061, at *1 (D.D.C. May 11, 1994) remanded by 74 F.3d 287 (D.C. Cir. 1996) (holding LLC interests are securities); Mark A. Sargent, *Will Limited Liability Companies Punch a Hole in the Blue Sky?*, 21 SEC. REG. L.J. 429 (1994).

The federal definition of “security” has served as a model for most modern state statutes. JOSEPH C. LONG, 1985 BLUE SKY LAW HANDBOOK § 2.01 (1988 revision).

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Section 5 of the 1933 Act provides that a registration statement must be in effect as to a non-exempt security before any means of transportation or communication in interstate commerce or of the mails may be used for the purpose of sale or delivery of such non-exempt security. The primary purpose of the 1933 Act is to provide a full disclosure of material information concerning public offerings of securities to investors. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976). The registration statement is the primary means for satisfying the full disclosure requirement. The 1933 Act (particularly §§ 5-7 and Schedule A) and Regulations C and S-K thereunder contain the general registration requirements. The Securities and Exchange Commission (“SEC”) has set forth a number of registration forms to be used under varying circumstances. Form S-1 is the basic form to be used by an issuer unless another form is specifically prescribed. There are basically three stages in the registration process: the pre-filing stage, the waiting period, and the post-effective stage. During the pre-filing stage, § 5(c) of the 1933 Act prohibits the use of interstate facilities (including telephones) or the mails to “offer to sell.” Further, § 5(a) prohibits sales or deliveries at any time before the “effective” date of the registration statement, which includes the pre-filing stage. The term sale is defined to include “every contract of sale or disposition of a security or interest in a security, for value.” During the waiting period, written offers are still prohibited, but oral offers are permitted. Since the registration statement is still not “effective,” sales or deliveries are still forbidden. During the post-effective stage, sales may be made freely. A prospectus satisfying the requirements under the 1933 Act must accompany any interstate or mailed “delivery” of the security if the prospectus has not preceded the delivery. See generally, LOUIS LOSS,

FUNDAMENTALS OF SECURITIES REGULATION ch. 2B (1988). Unlike the federal statute that seeks full disclosure, many of the state “blue sky” acts are based on a concept known as “merit regulation.” *Id.* at chs. 1B, 1C. Under these systems, the state securities administrator can prohibit a particular security from being offered in that state if the administrator determines that the terms of the offering are not “fair, just and equitable.” Most state acts do not define “fair, just and equitable.” In the Blue Sky Cases, the United States Supreme Court validated a number of state acts regulating securities on the basis that the acts neither violated the Fourteenth Amendment nor unduly burdened interstate commerce. *See Hall v. Geiger - Jones Co.*, 242 U.S. 539 (1917); *Caldwell v. Sioux Falls Stock Yards Co.*, 242 U.S. 559 (1917); *Merrick v. N.W. Halsey & Co.*, 242 U.S. 568 (1917).

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Section 4(2) of the 1933 Act exempts from the registration requirements of the 1933 Act “transactions by an issuer not involving any public offering” – generally referred to as “private placements.” The U.S. Supreme Court has held that the § 4(2) exemption must be interpreted in light of the statutory purpose of the 1933 Act to “protect investors by promoting full disclosure of information thought necessary to informed investment decisions” and that its applicability “should turn on whether the particular class affected needs the protection of the Act.” *S.E.C. v. Ralston Purina Co.*, 346 U.S. 119, 124-25 (1953). Subsequent court opinions have enumerated a number of more specific factors to be considered in determining whether a transaction involves a “public offering,” including the following:

- (a) the number of offerees (there is no number of offerees that always makes an offering either private or public; 25 to 35 is generally considered consistent with a private offering, but the sophistication of the offerees is more important; an offer to a single unqualified investor can defeat the exemption and an offering to a few hundred institutional investors can be exempt; note that the judicial focus is upon the number of persons to whom the securities are offered, not the number of actual purchasers);
- (b) offeree qualification (each offeree should be sophisticated and able to bear the economic risk of the investment; a close personal, family or employment relationship should also qualify an offeree);
- (c) manner of offering (the offer should be communicated directly to the prospective investors without the use of public advertising or solicitation);
- (d) availability of information (each investor should be provided or otherwise have access to information comparable to that contained in a registration statement filed under the 1933 Act; commonly investors are furnished a “private offering memorandum” describing the issuer and the proposed transaction in at least as much detail as would be found in a registration statement filed with the SEC for a public offering registered under the 1933 Act); and
- (e) absence of redistribution (the securities must come to rest in the hands of qualified purchasers and not be redistributed to the public; securities sold in a private placement generally may be replaced privately, freely sold by a person who is not an affiliate of the issuer in limited quantities to the public pursuant to SEC Rule 144, 17 C.F.R. 230.144 (2008), after a one-year holding period (if the issuer files reports with the SEC, the securities may be sold in limited quantities to the public pursuant to Rule 144 after a six-month holding period), or sold to the public pursuant to a registration statement filed and effective under the 1933 Act; the documentation of a private placement normally includes contractual restrictions on subsequent transfers of the securities purchased).

See 1933 Act Release No. 33-8869 (December 6, 2007); *Doran v. Petroleum Mgmt. Corp.*, 545 F.2d 893, 900 (5th Cir. 1977); Carl W. Schneider, *The Statutory Law of Private Placements*, 14 REV. SEC. REG. 869, 870 (1981); ABA Comm. on Fed. Regulation of Sec., *Integration of Securities Offerings: Report of the Task Force on Integration*, 41 BUS. LAW. 595, 595 (1986); C. Edward Fletcher, III, *Sophisticated Investors Under the Federal Securities Laws*, 1988 DUKE L. J. 1081, 1120-24 (1988).

SEC Regulation D (“Reg D”), 17 C.F.R. 230.501-506 (2007), became effective April 15, 1982 and is now the controlling SEC regulation for determining whether an offering of securities is exempt from registration under § 4(2) of the 1933 Act. Under Rule 506 of Reg D, there is no limitation on the dollar amount of securities that may be offered and sold, and the offering can be sold to an unlimited number of “accredited investors” (generally institutions, individuals with a net worth of over \$1 million and officers and directors and general

Prior to September 1, 1995, an LLC membership interest represented by a certificate would ordinarily have been considered a “security” for the purposes of Chapter 8 of the Texas Business and Commerce Code as in effect prior to that date (“Pre 9/1/95 B&CC”).¹⁴⁰³ Such an interest would ordinarily have been considered a “certificated security” under Pre 9/1/95 B&CC section 8.102 because it would have been (a) represented by an instrument issued in bearer or registered form; (b) of a type dealt in as a medium for investment; and (c) a class or series of shares, participations, interests or obligations. Under Pre 9/1/95 B&CC, security interests in certificated LLC interests would have been perfected by possession, as in the case of corporate

partners of the issuer) and to a maximum of thirty-five nonaccredited investors (there is no limit on the number of offerees so long as there is no general advertising or solicitation). Each of the purchasers, if not an accredited investor, must (either alone or through a representative) have such knowledge and experience in financial matters as to be capable of evaluating the risks and merits of the proposed investment. Unless the offering is made solely to accredited investors, purchasers must generally be furnished with the same level of information that would be contained in a registration statement under the 1933 Act. Resales of the securities must be restricted and a Form D notice of sale must be filed with the SEC. An offering which strictly conforms to the Reg D requirements will be exempt even if it does not satisfy all of the judicial criteria discussed above; however, since Reg D does not purport to be the exclusive means of compliance with § 4(2), a placement which conforms to the foregoing judicial standards also will be exempt from registration under § 4(2) of the 1933 Act, even if it does not strictly conform to Reg D.

After being approved by Congress with wide bipartisan support, on April 5, 2012, President Obama signed into law the Jumpstart Our Business Startups Act (the “JOBS Act”). The JOBS Act is an amalgamation of various bills the combined impact of which is intended to provide entrepreneurs, start-ups and small businesses increased access to the capital markets while at the same time provide average investors increased investment opportunities. The JOBS Act considerably alters the regulations surrounding public and private security offerings and, for certain issuers with revenues of less than \$1 billion, reduces the burden of certain periodic reporting obligations.

Title II of the JOBS Act will allow general solicitation and advertising (by all issuers, not just emerging growth companies) in connection with private offerings pursuant to Rule 506 of Regulation D and Rule 144A, provided that all purchasers in Rule 506 offerings are accredited investors and all purchasers in Rule 144A offerings are qualified institutional buyers. The JOBS Act does not alter state preemption of offerings under Rule 506. Additionally, the JOBS Act clarifies that certain persons acting to bring issuers and potential purchasers together for a Rule 506 offering will not be required to register with the SEC as a broker or dealer if that person complies with certain requirements, including that it may not receive compensation or have possession of customer funds in connection with the purchase or sale of the securities. The Title II provisions of the JOBS Act become effective upon SEC rulemaking.

¹⁴⁰² Section 3(a)(11) of the 1933 Act exempts from the registration requirements of the 1933 Act “any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within, or if a corporation, incorporated by and doing business within, such State or Territory.” Consequently there are two principal conditions to the intrastate offering exemption: (a) that the entire issue of securities be offered and sold exclusively to, and come to rest in the hands of, residents of the state in question (an offer or sale to a single non-resident will render the exemption unavailable to the entire issue); and (b) the issuer be organized under the laws of and doing substantial business in the state. Rule 147 promulgated under the 1933 Act articulates specific standards for determining whether an offering is intrastate within the meaning of Section 3(a)(11).

¹⁴⁰³ Act of June 17, 1983, 68th Leg., R.S., ch. 442, § 1, 1983 Tex. Gen. Laws 2511, *amended by* Act of June 16, 1995, 74th Leg., R.S., ch. 962, § 1, sec. 8.102, 1995 Tex. Gen. Laws 4760, 4761.

shares.¹⁴⁰⁴ Security interests in membership interests which were not evidenced by an instrument would have been perfected by a financing statement filing under Pre 9/1/95 B&CC section 9.¹⁴⁰⁵

As of September 1, 1995, LLC membership interests are not “securities” governed by Chapter 8 of the Texas Business & Commerce Code, as amended by House Bill 3200 (“Post 9/1/95 B&CC”), unless the interests are dealt in or traded on securities exchanges or markets or unless the parties expressly agree to treat them as such.¹⁴⁰⁶ Under Post 9/1/95 B&CC Chapter 9, LLC membership interests should be classified as “general intangibles,” whether or not represented by a certificate, and security interests would be perfected by a financing statement filing.¹⁴⁰⁷

Under the Tex. LLC Stats., a judgment creditor of a Member may on application to a court of competent jurisdiction secure a “charging order” against the Member’s membership interest.¹⁴⁰⁸ In a “charging order” a court “charges” the membership interest such that any distributions thereon are made as directed by the court, but does not order foreclosure of the

¹⁴⁰⁴ Pre 9/1/95 B&CC § 8.321.

¹⁴⁰⁵ A membership interest not represented by an instrument would be a “general intangible” under Pre 9/1/95 B&CC § 9.106. A security interest therein would attach as provided in Pre 9/1/95 B&CC § 9.203 when the debtor has signed a proper security agreement, value has been given and the debtor has rights therein, and would be perfected by a financing statement filing under Pre 9/1/95 B&CC § 9.302.

¹⁴⁰⁶ Post 9/1/95 B&CC §§ 8.102, 8.103(c).

¹⁴⁰⁷ Post 9/1/95 B&CC §§ 9.102(a)(42), 9.310. An LLC membership interest held in a securities account at a broker or dealer would be a “financial asset” and a “security entitlement” under Post 9/1/95 B&CC §§ 8.102(a)(17), 8.103(c) and 8.501(b)(1), and a security interest therein could be perfected by “control” or by filing under Post 9/1/95 B&CC §§ 9.106 and 9.115.

¹⁴⁰⁸ LLC Act § 4.06A, as amended in 2007 by 2007 H.B. 1737; TBOC § 101.112, which provides:

Sec. 101.112. MEMBER’S MEMBERSHIP INTEREST SUBJECT TO CHARGING ORDER. (a) On application by a judgment creditor of a member of a limited liability company or of any other owner of a membership interest in a limited liability company, a court having jurisdiction may charge the membership interest of the judgment debtor to satisfy the judgment.

(b) If a court charges a membership interest with payment of a judgment as provided by Subsection (a), the judgment creditor has only the right to receive any distribution to which the judgment debtor would otherwise be entitled in respect of the membership interest.

(c) A charging order constitutes a lien on the judgment debtor’s membership interest. The charging order lien may not be foreclosed on under this code or any other law.

(d) The entry of a charging order is the exclusive remedy by which a judgment creditor of a member or of any other owner of a membership interest may satisfy a judgment out of the judgment debtor’s membership interest.

(e) This section may not be construed to deprive a member of a limited liability company or any other owner of a membership interest in a limited liability company of the benefit of any exemption laws applicable to the membership interest of the member or owner.

(f) A creditor of a member or of any other owner of a membership interest does not have the right to obtain possession of, or otherwise exercise legal or equitable remedies with respect to, the property of the limited liability company.

See LLC Act § 7.03. TBOC § 101.112 provides substantially the same.

interest or compel any distributions. A charging order should not permit a judgment creditor of a Member to receive distributions on an interest subject to a prior perfected security interest. The TBOC provides that a charging order is a creditor's exclusive remedy against an LLC membership interest, but that does not preclude a member from granting a UCC security interest in a membership or enforcing it, in each case subject to the LLC's governing documents.

5.11. Assignment of Membership Interests. Unless otherwise provided in an LLC's Company Agreement, a Member's interest in an LLC is assignable in whole or in part.¹⁴⁰⁹ An assignment of a membership interest does not of itself dissolve the LLC or entitle the assignee to participate in the management and affairs of the LLC or to become, or to exercise any of the rights of, a Member.¹⁴¹⁰ An assignment entitles the assignee to be allocated income, gain, loss, deduction, credit or similar items, and receive distributions, to which the assignor was entitled to the extent those items are assigned and, for any proper purpose, to require reasonable information or account of transactions of the LLC and to make reasonable inspection of the books and records of the LLC.¹⁴¹¹ Until the assignee becomes a Member, the assignor continues to be a Member and to have the power to exercise any rights or powers of a Member, except to the extent those rights or powers are assigned.¹⁴¹² An assignee of a membership interest may become a Member if and to the extent that the Company Agreement so provides or all Members consent.¹⁴¹³ Until an assignee is admitted as a Member, the assignee does not have liability as a Member solely as a result of the assignment.¹⁴¹⁴

The Company Agreement would typically contain restrictions on the assignment of interests to facilitate compliance with applicable securities and tax laws. Membership interest transfer restrictions contained in the Company Agreement are enforceable.¹⁴¹⁵

5.12. Winding Up and Termination. The TBOC requires that an LLC commence winding up its affairs,¹⁴¹⁶ and the LLC Act provided that an LLC is dissolved, upon the occurrence of any of the following events (a "Winding Up Event"):

- (1) the expiration of the period (if any) fixed for its duration,¹⁴¹⁷ which may be perpetual;¹⁴¹⁸

¹⁴⁰⁹ LLC Act § 4.05A; TBOC § 101.108.

¹⁴¹⁰ *Id.*

¹⁴¹¹ LLC Act § 4.05A; TBOC § 101.109.

¹⁴¹² LLC Act § 4.05A; TBOC § 101.111.

¹⁴¹³ LLC Act § 4.07A; TBOC §§ 101.109(b); 101.052. Under Tex. LLC Stats., an assignee who becomes a Member (i) has (to the extent assigned) the rights and powers, and is subject to the restrictions of, a Member under the Company Agreement and the Tex. LLC Stats., and (ii) becomes liable for the obligations of the assignor to make contributions known to him at the time he becomes a member or as provided in the Company Agreement, although the assignment does not release the assignor from his liabilities to the LLC. LLC Act § 4.07B; TBOC §§ 101.110; 101.111(b).

¹⁴¹⁴ LLC Act § 4.05C; TBOC § 101.109(c).

¹⁴¹⁵ Tex. LLC Stats. provide that a membership interest is assignable unless otherwise provided by the Company Agreement. LLC Act § 4.05A; TBOC § 101.108(a). There is no statutory requirement of "reasonableness" with respect to LLC transfer restrictions as is found in TBCA art. 2.22 and TBOC §§ 21.211 and 21.213.

¹⁴¹⁶ TBOC § 11.001(8) defines winding up as the process of winding up the affairs of an LLC as a result of an event requiring its winding up.

- (2) the action of the Members to dissolve the LLC (in the absence of a specific provision in its certificate of formation or Company Agreement, the vote will be by a majority of the Members);¹⁴¹⁹
- (3) any event specified in its certificate of formation or Company Agreement to cause dissolution, or to require the winding up or termination, of the LLC;¹⁴²⁰
- (4) the occurrence of any event that terminates the continued membership of the last remaining Member of the LLC, absent certain circumstances;¹⁴²¹ or
- (5) entry of decree of judicial dissolution under the Tex. LLC Stats.¹⁴²²

¹⁴¹⁷ LLC Act §§ 3.02A(2), 6.01A(1); TBOC § 11.051(1); *see* 1993 LLC Bill Analysis at 4.

¹⁴¹⁸ Under TBOC § 3.003 an LLC exists perpetually unless otherwise provided in its certificate of formation or Company Agreement.

¹⁴¹⁹ LLC Act §§ 2.23D(2), 6.01A(3); TBOC §§ 11.051(2), 101.552. *See* 1993 LLC Bill Analysis at 5. Additionally, the TBOC provides that if there are no members, dissolution may occur upon the majority vote of the LLC’s managers. *See* TBOC § 101.552. This provision was intended to parallel the LLC Act provision which provided for dissolution upon the act of a majority of the Managers or Members named in the Articles, if no capital has been paid into the LLC and the LLC has not otherwise commenced business. LLC Act § 6.01A(4); *see* Revisor’s Note to TBOC § 101.552.

¹⁴²⁰ LLC Act § 6.01A(2); TBOC § 11.051(3).

¹⁴²¹ LLC Act § 6.01A(5), as amended by 2003 H.B. 1637 effective September 1, 2003; TBOC § 11.056. An LLC is not dissolved upon the termination of membership of the last remaining Member if the legal representative or successor of the last remaining Member agrees to continue the LLC and to become a Member as of the date of the termination of the last remaining Member’s membership in the LLC or designates another person who agrees to become a Member of the LLC as of the date of the termination. LLC Act § 6.01C as amended by 2003 H.B. 1637 effective September 1, 2003; TBOC § 11.056.

¹⁴²² LLC Act §§ 6.01A(6), 6.02A; TBOC § 11.051(5). The availability of judicial dissolution may not be modified by Regulations or Company Agreement under either the LLC Act or the TBOC. TBOC § 101.054(a)(6) expressly states that judicial dissolution may not be modified or waived by Company Agreement, and LLC Act § 6.02 does not provide for modification or waiver in Regulations. Although TBOC § 101.054 expressly states which provisions *cannot* be modified, its predecessor, the LLC Act, only expressly states which provisions *can* be modified. As the Revisor’s Note to TBOC § 101.052 explains:

Because of the reversal of the prior assumption that each provision of the [LLC Act] was mandatory (unless expressly qualified) to the new assumption in Sections 101.052 and 101.054 [of the TBOC] that most provisions of the code governing limited liability companies may be waived or modified, a number of the provisions of Title 3 are now stated in such a way that the new provision appears to be the converse of the corresponding provision under the Texas Limited Liability Company Act.

The Revisor’s Notes make no mention of any substantive change from the LLC Act to TBOC with respect to judicial dissolution, or the waivability thereof, because there was no substantive change. TBOC § 11.314—which is substantially similar to LLC Act § 6.02—is explicitly listed as being unwaivable under TBOC § 101.054. But under the LLC Act, all provisions are assumed mandatory unless it is explicitly stated that they are subject to variation by an LLC’s governing documents, and LLC Act § 6.02 contains no such qualification allowing modification or waiver of the right of judicial dissolution.

In contrast to the Texas LLC Stats. which do not permit the availability of judicial dissolution to be modified by Regulations or Company Agreement, the DLLCA permits an LLC agreement to waive judicial dissolution under DLLCA § 18-802. *R&R Capital, LLC v. Duck & Doe Run Valley Farms, LLC*, CA No. 3803-CC, 2008 WL 3846318 (Del. Ch. August 19, 2008) (LLC agreement could waive judicial dissolution under the DLLCA principle that LLCs “are creatures of contract, ‘designed to afford the maximum amount of freedom of contract, private ordering and flexibility to the parties involved’”). Just as DLLCA § 18-1101(e) expressly

Under the Tex. LLC Stats., the bankruptcy of a Member does not dissolve an LLC, or require its winding up or termination, unless its certificate of formation or Company Agreement so provides.¹⁴²³ In Delaware, however, the bankruptcy of a Member dissolves the LLC unless its LLC agreement otherwise provides.¹⁴²⁴

An LLC may in many cases cancel the event that would otherwise require winding up or termination and carry on its business. The procedures for doing so differ both by whether the LLC is governed by the TBOC or the LLC Act and by the type of Winding Up Event. Unless otherwise provided in its Company Agreement, the TBOC generally requires a majority vote of all the LLC's Members (or, if there are no Members, a majority vote of all its Managers) to revoke a voluntary winding up, and a unanimous vote of all of its Members to approve cancellation of an event that would otherwise require termination and winding up, other than a judicial decree.¹⁴²⁵

The time frames for permissible elections to continue in business also differ by governing law and type of Winding Up Event, and are all subject to restrictions in an LLC's governing documents. Where the Winding Up Event is the termination of the LLC's period of duration, the TBOC allows three years for cancellation, whereas the LLC Act requires an election to cancel within 90 days of the expiration, and subject to the amendment within three years of the LLC's formation document allowing for a longer duration.¹⁴²⁶ For a voluntary winding up, the LLC Act allows the LLC to cancel it within 120 days of the issuance of a certificate of dissolution, whereas the TBOC mandates that such election be made before the effective date of termination of the LLC's existence.¹⁴²⁷ For the occurrence of an event determined in the LLC's governing documents to require automatic dissolution, the LLC Act requires any cancellation election to be made within 90 days of the event, subject to amendment of the LLC's governing documents within three years to eliminate dissolution upon such event, while the TBOC allows one year to revoke such dissolution.¹⁴²⁸ For other circumstances requiring termination under the TBOC, LLCs are permitted one year to cancel the event of termination.¹⁴²⁹

Since (i) under the Check-the-Box Regulations continuity of life is not an issue in determining whether an LLC will be treated as a partnership for federal income tax purposes and (ii) there is considerable flexibility under the Tex. LLC Stats. in defining the circumstances in which an LLC is to be wound up or terminated, the certificate of formation and Company Agreement should henceforth focus on these events from a business rather than a tax standpoint.

states fiduciary duties may be eliminated by contract and the Tex. LLC Stats. do not so provide and do not allow that degree of contractual freedom to Texas LLCs, Texas differs from Delaware in that Texas LLCs do not have the power by Regulations or Company Agreement to eliminate the statutory right of judicial dissolution of a Texas LLC.

¹⁴²³ The bankruptcy of an entity is not a Winding Up Event under TBOC § 11.051.

¹⁴²⁴ DLLCA § 18-304.

¹⁴²⁵ TBOC §§ 101.552.

¹⁴²⁶ LLC Act § 6.01B; TBOC § 11.152(b).

¹⁴²⁷ LLC Act § 6.06A; TBOC § 11.151.

¹⁴²⁸ LLC Act § 6.01B; TBOC § 11.152(a).

¹⁴²⁹ TBOC § 11.152(a).

The result in many cases will be that the LLC will not dissolve until the parties take affirmative action to cause dissolution.

Upon the occurrence of a Winding Up Event, an LLC's affairs must be wound up as soon as practicable by its Managers, or Members or other persons as provided in its certificate of formation or Company Agreement or by resolution of the Managers or Members.¹⁴³⁰ Before filing a certificate of termination with the Secretary of State,¹⁴³¹ the LLC shall (i) cease to carry on its business, except as may be necessary for the winding up thereof, (ii) send written notice of its intention to dissolve to each of its known creditors and claimants,¹⁴³² and (iii) collect its assets, discharge its obligations or make provision therefor and distribute the remaining assets to its Members.¹⁴³³ In the event a dissolving LLC's assets are not sufficient to discharge its obligations, the LLC is required to apply the assets as far as they will go to the just and equitable payment of its obligations.¹⁴³⁴ Upon the filing of a certificate of termination with the Secretary of State, the existence of the LLC terminates except for the purpose of suits and other proceedings by Members, Managers and other LLC representatives.¹⁴³⁵

5.13. Foreign LLCs. The Tex. LLC Stats. provide a mechanism by which a limited liability company formed under the laws of another jurisdiction can qualify to do business in Texas as a foreign limited liability company (a "Foreign LLC") and thereby achieve in Texas the limited liability afforded by the Tex. LLC Stats. to a domestic LLC.¹⁴³⁶ The LLC Act defines Foreign LLC broadly so that business trusts and other entities afforded limited liability under the laws under which they were organized, but which would not qualify for LLC status if formed in Texas, can still qualify to do business and achieve limited liability in Texas.¹⁴³⁷ However, under the TBOC, such specific provision was unnecessary, as such entities may register directly to

¹⁴³⁰ LLC Act § 6.03A; TBOC § 101.551.

¹⁴³¹ For the required elements that must appear in a certificate of termination under the TBOC, see TBOC § 11.101. For entities governed by the LLC Act, the proper filing document was articles of dissolution. *See* LLC Act § 6.07.

¹⁴³² Under § 6.05 of the LLC Act, notice must be sent by registered or certified mail. Under the TBOC, notice must still be written, but can alternately be sent through a variety of technological means. *See* Revisor's Note to TBOC § 11.052.

¹⁴³³ LLC Act § 6.05; TBOC § 11.052.

¹⁴³⁴ LLC Act § 6.05(A)(3); TBOC § 11.053(b). The TBOC provides that such distribution may be delayed if continuing the business for a limited period will prevent unreasonable loss of the LLC property. *See* TBOC § 11.053(d).

¹⁴³⁵ LLC Act § 6.08(B); TBOC §§ 11.055, 11.102.

¹⁴³⁶ LLC Act Part Seven; TBOC chapter 101.

¹⁴³⁷ "Foreign limited liability company" is broadly defined in LLC Act § 1.02(9) as follows:

(9) "Foreign Limited Liability Company" means an entity formed under the laws of a jurisdiction other than this state (a) that is characterized as a limited liability company by such laws or (b) although not so characterized by such laws, that elects to procure a certificate of authority pursuant to Article 7.01 of this act, that is formed under laws which provide that some or all of the persons entitled to receive a distribution of the assets thereof upon the entity's dissolution or otherwise or to exercise voting rights with respect to an interest in the entity shall not be liable for the debts, obligations or liabilities of the entity and which is not eligible to become authorized to do business in this state under any other statute.

transact business in Texas under TBOC Chapter 9 and be afforded the limited liability shield.¹⁴³⁸ A foreign entity comparable to a Texas LLC and doing business in Texas registers and thereby qualifies to do business in Texas by filing an application to do so with the Secretary of State.¹⁴³⁹ The analysis of whether a Foreign LLC is doing business in Texas so as to require qualification is the same as for a foreign corporation.¹⁴⁴⁰

The internal affairs of a Foreign LLC, including the personal liability of its Members for its obligations, are governed by the laws of its jurisdiction of organization.¹⁴⁴¹ However, for matters affecting intrastate business in Texas, a Foreign LLC is subject to the same duties, restrictions, and liabilities as a domestic LLC.¹⁴⁴² The failure of a Foreign LLC to qualify to do business in Texas will not impair the limitation on liability of its Members or Managers, which gives specific effect to the applicability of the internal affairs doctrine relating to foreign entities in the case of a non-qualified Foreign LLC.¹⁴⁴³

5.14. Professional LLCs. Tex. LLC Stats. expressly provide for the formation of a professional limited liability company (a “PLLC”) and specify the statutory requirements for such entities.¹⁴⁴⁴ The pertinent provisions of the LLC Act (a predecessor to the TBOC), including the definition of “professional service,” were based upon the Texas Professional Corporation Act (“TPCA”).¹⁴⁴⁵ Unlike the TPCA, however, physicians, surgeons and other doctors of medicine are not excluded from forming PLLCs under the Tex. LLC Stats.¹⁴⁴⁶

¹⁴³⁸ See TBOC §§ 9.001 and 101.001 and the Revisor’s Notes thereto.

¹⁴³⁹ LLC Act §§ 7.01A, 7.05; TBOC §§ 9.001, 9.004.

¹⁴⁴⁰ LLC Act § 7.01B; TBCA art. 8.01B; TBOC § 9.251.

¹⁴⁴¹ LLC Act § 7.02 provides in relevant part as follows with respect to a Foreign LLC that has procured a certificate of authority from the Secretary of State to transact business in Texas pursuant to LLC Act Part Seven:

. . . only the laws of the jurisdiction of organization of a foreign limited liability company shall govern (1) the internal affairs of the foreign limited liability company, including but not limited to the rights, powers, and duties of its manager and members and matters relating to its ownership, and (2) the liability, if any, of members of the foreign limited liability company for the debts, liabilities and obligations of the foreign limited liability company for which they are not otherwise liable by statute or agreement.

The TBOC also provides for governance of a Foreign LLC’s internal affairs by the laws of its jurisdiction of organization. In fact, such governance is in the TBOC’s very definition of “foreign entity,” which states that the term “means an organization formed under, and the internal affairs of which are governed by, the laws of a jurisdiction other than this state.” TBOC § 1.002(28).

¹⁴⁴² LLC Act § 7.02A; TBOC § 9.203.

¹⁴⁴³ LLC Act § 7.13B; TBOC § 9.051(c).

¹⁴⁴⁴ See Part Eleven of the LLC Act; see also TBOC chapters 301 and 304. The Texas Disciplinary Rules of Professional Conduct permit Texas lawyers to form a Texas LLC for the practice of law. Op. Tex. Ethics Comm’n No. 486 (1994). Most (but not all) states will also allow attorneys to practice in an LLC, at least so long as the client is on notice of dealing with a limited liability entity and each lawyer rendering services to a client remains fully accountable to the client. Lance Rogers, *Questions of Law and Ethics Face Firms Becoming LLPs, LLCs*, 12 ABA/BNA Law. Manual on Prof. Conduct 411 (No. 23, Dec. 11, 1996); see ABA Comm. on Ethics and Prof’l Responsibility, Formal Op. 96-401 (1996).

¹⁴⁴⁵ TEX. REV. CIV. STAT. ANN. art. 1528e, §3(a) (Vernon 2011).

¹⁴⁴⁶ 1993 LLC Bill Analysis at 6; LLC Act § 11.01; TBOC §§ 301.003, 301.012.

A PLLC is required to contain in its name the words “Professional Limited Liability Company” or an abbreviation thereof.¹⁴⁴⁷ Only a “professional individual”¹⁴⁴⁸ or a “professional organization”¹⁴⁴⁹ may be a governing person¹⁴⁵⁰ of a PLLC.¹⁴⁵¹ The PLLC, but not the other individual Members, Managers or officers, is jointly and severally liable with a Member, Manager, officer, employee or agent rendering professional service for an error, omission, negligence, incompetence, or malfeasance on the part of the Member, Manager, officer, employee or agent when the Member, Manager, officer, employee or agent is rendering professional service in the course of employment for the PLLC.¹⁴⁵²

5.15. Series LLC. Subchapter M of TBOC Chapter 101¹⁴⁵³ was added in the 2009 Legislative Session¹⁴⁵⁴ to permit LLCs to establish series of members, managers, membership interests or assets to which different assets and liabilities may be allocated.¹⁴⁵⁵ The provisions are modeled after the series LLC provisions in DLLCA § 18-215. Through appropriate provisions in the Company Agreement and certificate of formation, the assets of one series can be isolated from the liabilities attributable to a different series.¹⁴⁵⁶ These provisions allow considerable flexibility in structuring LLCs in Texas. The provisions of Subchapter M generally have concepts similar to the Delaware provisions, but in many instances the wording has been revised to conform to the other provisions of the TBOC governing LLCs, including in particular the provisions relating

¹⁴⁴⁷ LLC Act § 11.02; TBOC § 5.059.

¹⁴⁴⁸ The LLC Act defines “professional individual” to mean an individual who is licensed or otherwise authorized to render the same professional service as the PLLC, either within Texas or in any other jurisdiction. LLC Act § 11.01B(3); TBOC § 301.003(5).

¹⁴⁴⁹ TBOC § 301.003(7). The LLC Act uses the alternate term “professional entity,” LLC Act § 11.01B(4), but either term indicates a person other than an individual that renders the same professional service as the PLLC, only through owners, members, employees, agents, and the like, each of whom is either a professional individual or professional organization or entity.

¹⁴⁵⁰ “Governing person” is a new term of art in the TBOC, and refers to a person entitled to manage and direct an entity’s affairs under the TBOC and the entity’s governing documents. TBOC §§ 1.001(37), (35). In terms of the LLC Act, the governing person would be the same as the members, if member-managed, and the managers if manager-managed.

¹⁴⁵¹ LLC Act § 11.03A; TBOC §§ 301.007(a), 301.004(2).

¹⁴⁵² LLC Act § 11.05; TBOC § 301.010.

¹⁴⁵³ TBOC §§ 101.601-101.521.

¹⁴⁵⁴ Rick Tulli & Daryl Robertson, *2009 Legislative Update on Texas Business Organizations Code Amendments*, 43:3 TEX. J. BUS. L. 571 (2009).

¹⁴⁵⁵ Elizabeth S. Miller, *Practical Pitfalls in Drafting Texas Limited Liability Company Agreements*, 45:1 TEX. J. BUS. L. 27 (2012); Adrienne Randle Bond & Allen Sparkman, *The Series LLC: A New Planning Tool*, 45:1 TEX. J. BUS. L. 57 (2012); Jennifer Avery, David Lawrence, Todd Lowther, Karen Rose, Joshua Russ, Brandon Schubert, Andrew Wootton & Travis Youngblood, *Series LLCs: Nuts and Bolts, Benefits and Risks, and the Uncertainties that Remain*, 45:1 TEX. J. BUS. L. 9 (2012).

¹⁴⁵⁶ Michelle Harner, Jennifer Ivey-Crickenberger & Tae Kim, *Series LLCs: What Happens When One Series Fails? Key Considerations and Issues*, ABA Business Law Today (Feb. 22, 2013), available at <http://apps.americanbar.org/buslaw/blt/content/2013/02/article-01-harner.shtml>; Allen Sparkman, *Series LLCs in Interstate Commerce*, ABA Business Law Today (Feb. 22, 2013), available at <http://apps.americanbar.org/buslaw/blt/content/2013/02/article-02-sparkman-a.shtml>; Allen Sparkman, *Tax Aspects of Series LLCs*, ABA Business Law Today (Feb. 22, 2013), available at <http://apps.americanbar.org/buslaw/blt/content/2013/02/article-03-sparkman-b.shtml>.

to winding-up and termination of the series.¹⁴⁵⁷ Each LLC series will have to file an assumed name certificate if it will have a name different from the LLC as will usually be the case.¹⁴⁵⁸

5.16. Diversity Jurisdiction. The cases are divided as to whether the citizenship of an LLC for federal diversity jurisdiction purposes should be determined by analogy to a partnership or a corporation. Where citizenship is determined in accordance with partnership precedent, an LLC is deemed a citizen of each state in which it has a Member.¹⁴⁵⁹ Where corporate precedent is applied, an LLC is a citizen of its state of incorporation and the state where its principal place of business is located.¹⁴⁶⁰

CHAPTER 6. LIMITED LIABILITY PARTNERSHIP.

6.1. General. An LLP is a general partnership in which the individual liability of partners for partnership obligations is substantially limited. This species of general partnership represents a dramatic innovation and was first authorized in 1991 by provisions (the “LLP Provisions”) added to the TUPA by Sections 83-85 of House Bill 278 (“1991 H.B. 278”).¹⁴⁶¹ The LLP Provisions were refined and carried forward as section 3.08 of the TRPA¹⁴⁶² passed in 1993, and then were substantially expanded by 1997 S.B. 555 effective September 1, 1997 (“1997 S.B. 555”).¹⁴⁶³ The LLP Provisions were substantially revised and made more protective in the 2011 Legislative Session, effective September 1, 2011, by 2011 S.B. 748.

The LLP provisions initially appearing in the TBOC¹⁴⁶⁴ took effect on January 1, 2006 and governed all LLPs formed on or after that date.¹⁴⁶⁵ The source LLP Provisions in TRPA governed LLPs formed before that date which did not voluntarily opt in to TBOC governance until their registrations expired, unless they are revoked or withdrawn prior to expiration, and,

¹⁴⁵⁷ Rick Tulli & Daryl Robertson, *2009 Legislative Update on Texas Business Organizations Code Amendments*, 43:3 TEX. J. BUS. L. 571 (2009).

¹⁴⁵⁸ See *infra* notes 1518-1522 and related text.

¹⁴⁵⁹ *International Flavors & Textures, LLC v. Gardner*, 966 F.Supp. 552 (W.D. Mich. 1997).

¹⁴⁶⁰ *SMS Fin. II, L.L.C. v. Stewart*, 1996 WL 722080 (N.D. Tex. 1996); *Carlos v. Adamany*, 1996 WL 210019 (N.D. Ill. 1996).

¹⁴⁶¹ Tex. H.B. 278, 72d Leg., R.S. (1991). See R. Dennis Anderson, Alan R. Bromberg, Byron F. Egan, Campbell A. Griffin, Larry L. Schoenbrun and Charles Szalkowski, *Registered Limited Liability Partnerships*, Vol. 28, No. 3 BULL. OF SEC. OF BUS. L. 1 (Jan. 1992); reprinted 55 TEX. B. J. 728 (July 1992).

¹⁴⁶² TRPA § 1.01 et seq.

¹⁴⁶³ Tex. S.B. 555, 75th Leg., R.S. (1997). Under TRPA § 11.03(b), TRPA § 3.08 governs all LLPs between January 1, 1994 and December 31, 2005 (regardless of when formed). Its coverage continues until December 31, 2009 for those LLPs formed prior to January 1, 2006 but not opting into the TBOC. However, an LLP formed before January 1, 1994 and governed by the TRPA is subject to TUPA for the purposes of determining liability for acts occurring prior to January 1, 1994. The TRPA phase-in provisions relating to LLPs deal only with the LLP Provisions in TRPA § 3.08. The other aspects of a partnership entity which is an LLP are governed by the remaining provisions of TRPA which have a different statutory phase-in. TRPA § 11.03 provides that, except for § 3.08, TRPA applies on and after January 1, 1994 to (i) new partnerships formed on and after that date and (ii) existing partnerships which elect to be governed by TRPA; and all partnerships will be governed by TRPA after January 1, 1999 (though again, subject to the phase in of the TBOC).

¹⁴⁶⁴ See TBOC Title 1 and §§ 152.801-152.805.

¹⁴⁶⁵ TBOC §§ 401.001, 402.003, 402.005.

after January 1, 2010, all LLPs (like all other Texas entities) became subject to the TBOC.¹⁴⁶⁶ The LLP Provisions or TBOC LLP provisions, as each may be applicable to a particular LLP, will be hereinafter collectively referred to as “Tex. LLP Stats.,” with differences between the two noted as appropriate.

6.2. Evolution of the LLP in Texas.

6.2.1. First LLP in 1991 in Texas. The LLP Provisions of TUPA originated in 1991 in Senate Bill 302 (“1991 S.B. 302”)¹⁴⁶⁷ as an alternate means for allowing professionals the limitation of liability already available to them under the Texas Professional Corporation Act.¹⁴⁶⁸ Although that statute allows professionals to limit their liability, the federal income tax consequences of joining and separating from professional corporations often made this avenue unavailable as a practical matter. The solution embodied in 1991 S.B. 302 was to amend TUPA to allow professionals to achieve through a new kind of partnership the same liability limitation already available in corporate form.¹⁴⁶⁹ Thus, the proposed amendments to TUPA that were contained in 1991 S.B. 302 applied only to certain kinds of professional partners: physicians, surgeons, other doctors of medicine, architects, attorneys at law, certified public accountants, dentists, public accountants and veterinarians. 1991 S.B. 302 passed the Senate but encountered criticism in hearings before the House Business and Commerce Committee on grounds, among others, that 1991 S.B. 302 was discriminatory against non-professional partnerships, that 1991 S.B. 302 did not tell persons dealing with a partnership whether the partnership had the liability shield, and that 1991 S.B. 302 did not require any substitute source of recovery for a person injured by partnership misconduct.¹⁴⁷⁰ These criticisms led to the enlargement of the LLP Provisions to be applicable to all partnerships, and to the addition of the requirements of LLP registration with the Secretary of State, use of LLP status words or initials in the partnership name and maintenance by LLP’s of liability insurance. In this form, the LLP Provisions were added to 1991 H.B. 278 in the Senate, and the House concurred in 1991 H.B. 278 as so amended. With the adoption of TRPA in House Bill 273 (“1994 H.B. 273”) in 1994, the LLP Provisions of TUPA were refined and carried over into TRPA.

The LLP Provisions originated as part of a liability limiting trend that has included (i) the LLC Act; (ii) amendments to the Texas Professional Corporation Act in 1989 and in 1991 H.B. 278; (iii) the passage of TRPA in 1994 H.B. 273, maintaining the LLP entity created by 1991 H.B. 278; (iv) the 1989 and 1993 amendments to TBCA article 2.21 to clarify non-liability of shareholders for corporate contractual obligations; (v) the passage of TRLPA in 1987, which allowed limited partners to engage in widely expanded activities without sacrificing their limited liability; and (vi) the 1987 enactment and subsequent amendment of TMCLA art. 1302-7.06 authorizing the limitation of liability of directors. These legislative changes were made during a period of increasing litigation against individuals for actions that they allegedly took, or failed to

¹⁴⁶⁶ TBOC § 402.001(b). Even prior to January 1, 2010, LLP registration renewal was governed by the TBOC after January 1, 2006 under TBOC § 402.001(c). *See supra* notes 42-44 and related text.

¹⁴⁶⁷ Senate Bill 302 by Sen. John Montford (“1991 S.B. 302”).

¹⁴⁶⁸ TEX. REV. CIV. STAT. ANN. art. 1528e (Vernon Supp. 2010).

¹⁴⁶⁹ *See* Hamilton, *Registered Limited Liability Partnerships: Present at the Birth (Nearly)*, 66 U. COLO. L. REV. 1065 (1995).

¹⁴⁷⁰ *See* TEX. LAW. 7 (May 13, 1991); TEX. LAW. 1 (Oct. 21, 1991).

take, while serving as directors, officers or partners of a firm that failed or provided services to a firm that failed. This litigation often involved amounts that dwarfed the net worth of the individuals involved.

6.2.2. LLP Now Nationwide. The LLP has spread beyond its Texas roots, and now every state has adopted an LLP statute. As the adoption of LLP statutes became more widespread, the LLP statutes of an increasing number of states protected partners from liabilities arising other than from the negligence, malpractice, wrongful acts or misconduct of other partners and employees.¹⁴⁷¹ The “full shield” LLP statutes of a number of states (including Colorado, Georgia, Idaho, Indiana, Maryland, Minnesota and New York) insulate a partner from personal liability for any debts, obligations or liabilities of, or chargeable to, the partnership, if such liability would exist solely by reason of their being partners, rendering professional services, or participating in the conduct of the business of the LLP, but do not protect a partner from liability arising from the partner’s own negligence, wrongful acts or misconduct, or from that of any person acting under his direct supervision and control.¹⁴⁷²

6.2.3. 1997 Amendment to Limit Contract Liabilities. Although Texas was the first jurisdiction in the nation to permit the creation of LLPs, TRPA lagged behind other jurisdictions in providing partners of LLPs with protection from liabilities of the partnership. To address this deficiency, 1997 S.B. 555 amended TRPA section 3.08 in 1997 to bring the Texas statute more in line with the laws of other jurisdictions relating to LLPs, in particular the liability of partners of an LLP for contractual obligations. TRPA section 3.08(a), as so amended, provided that, except for liability for errors, omissions, negligence, incompetence or malfeasance committed by, or attributed to, a partner in an LLP, a partner will not be individually liable, directly or indirectly, by contribution, indemnity or otherwise, for the debts and obligations of the partnership incurred while the partnership is an LLP.¹⁴⁷³

A new subsection (5) was added to TRPA section 3.08(a) by 1997 S.B. 555¹⁴⁷⁴ to provide that in the case of an LLP, the limitations of liability provided in section 3.08(a) will prevail over other parts of TRPA regarding the liability of partners, their chargeability for the debts and obligations of the partnership and their obligations regarding contributions and indemnity. The amendment to TRPA section 3.08 relating to limitation of liability of partners of an LLP did not impair the obligations under a contract existing before the effective date of 1997 S.B. 555.¹⁴⁷⁵ Thus, the partners of an LLP which was subject to a long-term lease entered into prior to September 1, 1997 remained personally liable for those lease obligations notwithstanding the amendment of TRPA section 3.08, although they would be shielded against contractual obligations created thereafter. Similarly, for organizations subject to the TBOC, the TBOC’s

¹⁴⁷¹ See, e.g., N.Y. Partnership Law § 26(b) (McKinney 1988 & Supp.); Hamilton, *Registered Limited Liability Partnerships: Present at Birth (Nearly)*, 66 U. COL. L. REV. 1065, 1097 (1995).

¹⁴⁷² N.Y. Partnership Law § 26(c), (d) (McKinney 1988 & Supp.).

¹⁴⁷³ TRPA § 3.08.

¹⁴⁷⁴ The TBOC’s parallel provision is in § 152.801(f).

¹⁴⁷⁵ 1997 S.B. 555 § 125(d) provides as follows:

(d) The change to Article 3.08, Texas Revised Partnership Act (Article 6132b-3.08, Vernon’s Texas Civil Statutes), made by this Act shall not impair the obligations of a contract existing before the effective date of this Act.

provisions govern contracts the LLP enters on and after the first date the TBOC applies to the LLP, but prior law governs any contracts entered into under such old law.¹⁴⁷⁶

TRPA section 8.06 was amended by 1997 S.B. 555 to clarify that the obligations of a partner to make contributions to a partnership for the partner's negative balance in the partner's capital account and to satisfy obligations are subject to the limitations contained in TRPA sections 3.07 and 3.08 relating to LLPs and the liability of incoming partners.

The amendment to TRPA section 3.08 making Texas a full shield state did not apply to contractual obligations incurred prior to the September 1, 1997 effective date of 1997 S.B. 555 by virtue of 1997 S.B. 555 section 125(d), which provided as follows:

“(d) The change to Article 3.08, Texas Revised Partnership Act (Article 6132b-3.08, Vernon's Texas Civil Statutes), made by this Act shall not impair the obligations of a contract existing before the effective date of this Act.”

Such obligations were similarly unshielded for partnerships governed by the TBOC.¹⁴⁷⁷ Thus, the partners of an LLP which was subject to a long term lease entered into prior to September 1, 1997 remained personally liable for those lease obligations notwithstanding the amendment of TRPA section 3.08, although the same obligation incurred thereafter would be shielded unless the partners had agreed to be liable therefor.

6.2.4. Insurance Requirement. A requirement for LLP status under the Tex. LLP Stats. prior to 2011 S.B. 748 was that the partnership must:

- (1) carry at least \$100,000 of liability insurance of a kind that is designed to cover the kind of error, omission, negligence, incompetence, or malfeasance for which liability is limited by Section 152.801(b); or
- (2) provide \$100,000 specifically designated and segregated for the satisfaction of judgments against the partnership for the kind of error, omission, negligence, incompetence, or malfeasance for which liability is limited by Section 152.801(b) by:
 - (A) deposit of cash, bank certificates of deposit, or United States Treasury obligations in trust or bank escrow;
 - (B) a bank letter of credit; or
 - (C) insurance company bond.¹⁴⁷⁸

The requirement that the partnership “carry at least \$100,000 of liability insurance of a kind that is designed to cover the kind of error, omission, negligence, incompetence, or malfeasance for which liability is limited by” the Tex. LLP Stats. (and the option to provide \$100,000 of funds instead) was intended to provide some source of recovery as a substitute for the assets of partners

¹⁴⁷⁶ TBOC § 402.006.

¹⁴⁷⁷ TBOC § 402.006.

¹⁴⁷⁸ TBOC § 152.804(a). TRPA § 3.08(d)(1) provided substantially the same. The partnership should, of course, be a named insured. While a policy naming only the partners may suffice, caution suggests not relying on this approach.

who were shielded from liability by the Tex. LLP Stats. The \$100,000 figure was arbitrary and might or might not be greater than the partners' individual assets otherwise available to partnership creditors. Nevertheless, the maintenance by the LLP of the required \$100,000 of insurance or segregated funds at the time a liability was incurred was a requirement for the liability to be shielded, and it was not sufficient that a partner individually maintains insurance in such amount.¹⁴⁷⁹

The \$100,000 requirement referred to the liability limit of the insurance, above any deductibles, retentions or similar arrangements; thus, deductibles, retentions and the like were permitted so long as the coverage would allow aggregate proceeds of at least \$100,000. The statute was not explicit about the effect on one claim of exhaustion of the policy limits by a prior claim. The intent was clear that exhaustion by one claim does not remove the liability shield for the same claim. If an LLP had the requisite insurance in place at the time the error or omission occurred, the insurance requirement should be satisfied even though subsequent events made the coverage unavailable to the aggrieved party. For example, if there were a number of lawsuits pending against an LLP at the time an error or omission occurred and judgments subsequently entered depleted the insurance available for the aggrieved party, the subsequent events should not retroactively deny the LLP shield to the partnership. Renewal or replacement of policies on their periodic expirations is probably enough to satisfy the insurance requirement of TRPA section 3.08(d) and TBOC section 152.804.

The insurance had to be “designed to cover the kinds of” acts for which partner liability was shielded by Tex. LLP Stats.¹⁴⁸⁰ The quoted phrase contained some flexibility; actual coverage of the misconduct that occurs was not an absolute necessity. The partner claiming the shield from liability, however, had the burden of proof that the insurance satisfied this statutory requirement.

Insurance coverage for particular conduct was not always available. TRPA section 3.08(d) and TBOC section 152.804(a) allowed an LLP the option of providing \$100,000 in funds in lieu of obtaining insurance, but require one or the other. Proof of compliance with the insurance or financial responsibility requirements was on the partner claiming the liability shield of TBOC section 152.801 or TRPA section 3.08(a).¹⁴⁸¹

¹⁴⁷⁹ In *Elmer v. Santa Fe Props., Inc.*, No. 04-05-00821-CV, 2006 WL 3612359 (Tex. App.—San Antonio 2006, no pet.), a partner of an LLP was held personally liable for the LLP's obligations under a lease executed at a time when the LLP was not in compliance with the requirement of the applicable LLP Stats. that an LLP maintain liability insurance of at least \$100,000 “of a kind that is designed to cover the kinds of errors, omissions, negligence, incompetence, or malfeasance for which liability is limited by” the LLP Stats. It did not matter that (i) a judgment was first obtained against the partnership on pleadings alleging that the partnership was an LLP, (ii) the individual partner sued in the case had actually maintained errors and omissions coverage for himself individually (the Tex. LLP Stats. require that the insurance cover the partnership and covering an individual partner is not good enough—substantial compliance is not enough under the Tex. LLP Stats: strict compliance is required), and (iii) the liability at issue was a contract obligation rather than the kind of tort liability for which the statutorily required insurance would provide coverage. See Elizabeth S. Miller, *Are There Limits on Limited Liability? Owner Liability Protection and Piercing the Veil of Texas Business Entities*, 43 TEX. J. BUS. L. 405, 440 (Fall 2009).

¹⁴⁸⁰ TRPA § 3.08(d)(1)(A); TBOC § 152.804(a)(1).

¹⁴⁸¹ See TRPA § 3.08(d)(3); TBOC § 152.804(c).

The Tex. LLP Stats. provided that the LLP insurance requirements “shall not be admissible nor in any way made known to the jury in determining the issue(s) of liability for or extent of the debt or obligation or damages in question.”¹⁴⁸² These provisions were intended to keep the existence of insurance from influencing a jury decision on liability or damages. The Tex. LLP Stats. specifically stated that if compliance with their insurance or fund provisions was disputed, “compliance must be determined separately from the trial or proceeding” to determine liability or damages.¹⁴⁸³

6.2.5. TBOC Prior to 2011 SB 748. The TBOC as originally adopted afforded LLP partners the same protection as TRPA section 3.08(a), although the TBOC in referring to the LLP dropped the “registered” in limited liability partnership and referred to an LLP as a limited liability partnership.¹⁴⁸⁴ This provision, however, did not apply to the liability of a partnership to pay its debts and obligations out of partnership property, the liability of a partner, if any, imposed by law or contract independently of the partner’s status as a partner, or the manner in which service of citation or other civil process may be served in an action against the partnership. Prior to 2011 S.B. 748, the LLP shield in TBOC § 152.801 protected a partner in an LLP from both tort and contract liabilities of the LLP.

Partners in a general partnership that is not an LLP are individually liable, jointly and severally, for all partnership obligations, including partnership liabilities arising from the misconduct of other partners, although under Texas law a creditor generally must first seek to satisfy the obligations out of partnership property.¹⁴⁸⁵ Although an LLP is a general partnership, the general partnership joint and several liability scheme is dramatically altered by the Tex. LLP Stats. when LLP status is attained.

The essence of the Tex. LLP Stats. prior to 2011 S.B. 748 was to relieve a partner from individual liability for partnership obligations, except to the extent that they are attributable to the fault of the partner. The shield was set forth in TBOC § 152.801 (prior to 2011 S.B. 748) as follows:

Sec. 152.801. Liability of Partner.

(a) Except as provided by Subsection (b) or the partnership agreement, a partner in a limited liability partnership is not personally liable to any person, including a partner, directly or indirectly, by contribution, indemnity, or otherwise, for a debt or obligation of the partnership incurred while the partnership is a limited liability partnership.¹⁴⁸⁶

¹⁴⁸² TRPA § 3.08(d)(2); *see also* TBOC § 152.804(b).

¹⁴⁸³ TRPA § 3.08(d)(3); *see also* TBOC § 152.804(c).

¹⁴⁸⁴ TBOC §§ 1.002(48) and 152.801-152.805.

¹⁴⁸⁵ TRPA § 3.05(a), (d), (e); TBOC § 152.306(b). *See Bromberg & Ribstein, supra* note 1100, § 1.01 and ch. 5 for a general discussion of the liabilities of general partners.

¹⁴⁸⁶ In *Evanston Ins. Co. v. Dillard Dep’t Stores, Inc.*, 602 F.3d 610 (5th Cir. 2010), the Fifth Circuit held that the partners in an LLP were personally liable for trademark infringement and business torts that occurred when the partnership was an LLP because the judgment creating the partnership “debt” was entered after the partnership dissolved and its LLP registration had expired. The facts of the case elucidate why the Fifth Circuit reached a result that appears inconsistent with both the intent and the wording of the Tex. LLP Stats. The two defendants formed a law partnership in 2002, registered it as an LLP and prosecuted

lawsuits against plaintiff (“Dillard’s”), alleging that Dillard’s racially discriminated against its customers. In an attempt to solicit business, the firm developed a website which included a link using the “Dillard’s” name and logo. Clicking this link took visitors to dillardsalert.com, a separate website documenting acts of alleged racial profiling by the department stores. Dillard’s sued the firm for trademark infringement and various business torts. It sought damages and an injunction against CELLP’s use of its trademark.

In 2004, while the litigation continued, the partners executed a separation agreement that provided for “dissolution” of the partnership, and the partnership’s registration as an LLP was not renewed and expired. Notwithstanding these facts, the defunct LLP remained a party to the Dillard’s litigation, no party was substituted on its behalf, and a final judgment was entered ordering the LLP to pay Dillard’s \$143,500. Dillard’s attempt to collect on the judgment did not succeed and ultimately it sued the two lawyers individually for the obligations of the partnership.

In affirming on other grounds the district court holding which had stated that the partners became personally liable because they did not wind up the business upon dissolution of the partnership and expiration of the LLP registration, the Fifth Circuit explained:

Appellants [the LLP partner defendants] argue that [TRPA] § 3.08(a)(1) insulates them from liability because CELLP’s debt was incurred when the infringing website was created in June 2003, at which time CELLP was still a registered limited liability partnership. Dillard’s, meanwhile, contends that the debt was incurred when the judgment was entered on November 2, 2004, at which time the erstwhile LLP had lost its liability-limiting attributes.

* * *

Although the terms “debt” and “incurred” are not defined by the TRPA, a plain reading of the statute’s text supports Dillard’s proffered interpretation. Neither partner was necessarily aware in June 2003 that displaying the Dillard’s mark on the law firm website would ultimately lead to a partnership debt. The underlying conduct gave rise to the possibility of a future debt, but to say that a debt was “incurred” at that time unrealistically distorts the meaning of the word. After all, CELLP’s conduct may have gone undetected, it may have been adjudged perfectly innocent, or Dillard’s may have opted not to sue. Under any of those scenarios, no debt would ever have been incurred, let alone incurred in June 2003. It was only when the district court entered judgment against CELLP in November 2004 that a payable debt came into existence. It was then that CELLP incurred the debt within the meaning of the provision.

Moreover, the neighboring language of § 3.08(a)(2) demonstrates that the Texas legislature, when it so chooses, is capable of drafting a provision that focuses on the commission of events that lead to liability, rather than the fixing of consequent liability from those events. In that provision, the legislature insulated an LLP partner from personal liability “arising from errors, omissions, negligence, incompetence, or malfeasance committed “ by another partner “while the partnership is a registered limited liability partnership.” TRPA § 3.08(a)(2) (emphasis added). Thus, to decide whether the first partner’s liability is limited for the second partner’s malfeasance under § 3.08(a)(2), a court must look to when the second partner committed the malfeasance. Had the legislature intended to enact the same “when committed” approach for § 3.08(a)(1), it could have used the language from § 3.08(a)(2). [Citation omitted] It chose, however, to use different language, and created a regime in which partners could be held individually liable for debts and obligations incurred when the partnership was not a registered LLP [§ 3.08(a)(1)], but in which partners would not bear liability for one another’s independent malfeasance committed while the LLP existed [§ 3.08(a)(2)].

Because CELLP’s registration had expired, it was not a valid registered LLP at the time its debt was incurred. Therefore, § 3.08 does not foreclose individual liability and § 3.04’s default rule operates to hold appellants personally liable for CELLP’s debt.

(b) A partner in a limited liability partnership is not personally liable for a debt or obligation of the partnership arising from an error, omission, negligence, incompetence, or malfeasance committed by another partner or representative of the partnership while the partnership is a limited liability partnership and in the course of the partnership business unless the first partner:

- (1) was supervising or directing the other partner or representative when the error, omission, negligence, incompetence, or malfeasance was committed by the other partner or representative;
- (2) was directly involved in the specific activity in which the error, omission, negligence, incompetence, or malfeasance was committed by the other partner or representative; or
- (3) had notice or knowledge of the error, omission, negligence, incompetence, or malfeasance by the other partner or representative at the time of the occurrence and then failed to take reasonable action to prevent or cure the error, omission, negligence, incompetence, or malfeasance.

(c) Sections 2.101(1), 152.305, and 152.306 do not limit the effect of Subsection (a) in a limited liability partnership.

(d) In this section, “representative” includes an agent, servant, or employee of a limited liability partnership.

(e) Subsections (a) and (b) do not affect:

- (1) the liability of a partnership to pay its debts and obligations from partnership property;
- (2) the liability of a partner, if any, imposed by law or contract independently of the partner’s status as a partner; or
- (3) the manner in which service of citation or other civil process may be served in an action against a partnership.

(f) This section controls over the other parts of this chapter and the other partnership provisions regarding the liability of partners of a limited liability partnership, the chargeability of the partners for the debts and obligations of the partnership, and the obligations of the partners regarding contributions and indemnity.¹⁴⁸⁷

See Elizabeth S. Miller, Are There Limits on Limited Liability? Owner Liability Protection and Piercing the Veil of Texas Business Entities, 43 TEX. J. OF BUS. L. 405, 435-445 (Fall 2009).

¹⁴⁸⁷

The provisions of TBOC § 152.801 prior to 2011 S.B. 748 were substantially the same as those found in TRPA § 3.08(a), except that TBOC § 152.801(a) was amended as follows in the 2009 Legislative Session by 2009 S.B. 1442 § 47 without a corresponding change being made to TRPA § 3.08(a):

SECTION 47. Subsection (a), Section 152.801, Business Organizations Code, is amended to read as follows:

(a) Except as provided by Subsection (b) or the partnership agreement, a partner in a limited liability partnership is not personally liable to any person, including a partner, directly or indirectly, by contribution, indemnity, or otherwise, for a debt or obligation of the partnership incurred while the partnership is a limited liability partnership.

The Tex. LLP Stats. prior to 2011 S.B. 748 expressly did not relieve a partner for any liability imposed by law or contract independently of his status as a partner.¹⁴⁸⁸ In addition, there were three situations in which the LLP Provisions did not shield a partner from liability for a partnership obligation arising from the specified misconduct of a copartner or representative of the partnership:

- (1) The miscreant copartner or representative was working under the supervision or direction of the partner.¹⁴⁸⁹
- (2) The partner was directly involved in the specific activity in which the copartner or representative commits the misconduct.¹⁴⁹⁰
- (3) The partner had “notice” or “knowledge” of the misconduct at the time of occurrence and fails to take reasonable steps to prevent the misconduct.¹⁴⁹¹

All three situations involve fact questions as well as legal interpretations of the statutory language.

In situation (1), the supervision should be direct, or the direction should be specific, for the exception to apply. The language in situation (1) was not intended to deny the liability shield to someone (such as a managing or senior partner) who exercises indirect supervision over all partnership activity or over a particular segment of the partnership’s business or who generally directs other partners by establishing policies and procedures or by assigning responsibilities.

In situation (2), the direct involvement should relate to the particular aspect of the endeavor in which the misconduct occurred. The language in situation (2) was not intended to deny the liability shield to someone who was directly involved in one facet of a multifaceted matter (e.g., one involving several different areas of expertise) but did not participate in that facet of the matter that gave rise to the liability.

Neither exception (1) nor (2) should denude someone who had direct supervisory responsibility for, and therefore was directly involved in, a particular project but was not directly supervising the person who engaged in misconduct or directly involved in the aspect of the project in which the misconduct occurred.¹⁴⁹² For example, an environmental lawyer who

¹⁴⁸⁸ TRPA § 3.08(a)(3)(B); TBOC § 152.801(e).

¹⁴⁸⁹ TRPA § 3.08(a)(2); TBOC § 152.801(b)(1).

¹⁴⁹⁰ TRPA § 3.08(a)(2)(A); TBOC § 152.801(b)(2).

¹⁴⁹¹ TRPA § 3.08(a)(2)(B); TBOC § 152.801(b)(3). Tex. LLP Stats. provided prior to 2011 S.B. 748 that a person has “notice” of a fact if such person (i) has actual knowledge of such fact, (ii) has received a communication of the fact, or (iii) reasonably should have concluded, from all facts known to such person at the time in question, that the fact exists. A person is treated as having received a communication of a fact if the fact is communicated to the person, the person’s place of business, or another place held out by the person as the place for receipt of communications. TRPA § 1.02; TBOC § 151.003.

¹⁴⁹² *But see* Fortney, *Am I My Partner’s Keeper? Peer Review in Law Firms*, 66 U. COL. L. REV. 329, 331-32 (1995) (notes that in six “actions brought in connection with failed savings and loan associations, the government has alleged that *each law firm partner is personally liable for failing to monitor* the conduct of

negligently rendered legal advice with respect to the environmental law aspects of a real property acquisition would not ordinarily be viewed as “working under the supervision or direction” of a real estate lawyer having overall responsibility for the acquisition (which means that exception (1) would not be applicable), and the real estate lawyer would not ordinarily be viewed as “involved in the specific activity” (i.e., advising with respect to environmental law) in which the misconduct occurred (which means that exception (2) would not apply).

6.3. Liability Shielded After 2011 S.B. 748. The individual liability of partners of a general partnership that is an LLP is even more drastically altered after 2011 S.B. 748. The essence of the LLP liability shield continues to be that a partner in an LLP is not liable for the tort or contract liabilities of the partnership incurred while it is an LLP, but 2011 S.B. 748 removed wording in the LLP Provisions that a partner could have responsibility for the actions of another partner where the partner was supervising or involved in the actions of the miscreant partner or aware of the miscreant partner’s actionable conduct.¹⁴⁹³ A partner, however, is always liable for

other firm partners. * * * In making such allegations the government has asserted that the failure to monitor claims are distinct from the vicarious liability claims,” for which the LLP shield was designed).

¹⁴⁹³ 2011 S.B. 748 § 46 provided as follows:

SECTION 46. Section 152.801, Business Organizations Code, is amended to read as follows:

Sec. 152.801. LIABILITY OF PARTNER. (a) Except as provided by [~~Subsection (b) or~~] the partnership agreement, a partner [~~in a limited liability partnership~~] is not personally liable to any person, including a partner, directly or indirectly, by contribution, indemnity, or otherwise, for any [~~a debt or~~] obligation of the partnership incurred while the partnership is a limited liability partnership.

(b) [~~A partner in a limited liability partnership is not personally liable for a debt or obligation of the partnership arising from an error, omission, negligence, incompetence, or malfeasance committed by another partner or representative of the partnership while the partnership is a limited liability partnership and in the course of the partnership business unless the first partner:~~

[~~(1) — was supervising or directing the other partner or representative when the error, omission, negligence, incompetence, or malfeasance was committed by the other partner or representative;~~

[~~(2) — was directly involved in the specific activity in which the error, omission, negligence, incompetence, or malfeasance was committed by the other partner or representative; or~~

[~~(3) — had notice or knowledge of the error, omission, negligence, incompetence, or malfeasance by the other partner or representative at the time of the occurrence and then failed to take reasonable action to prevent or cure the error, omission, negligence, incompetence, or malfeasance.~~

[~~(e)~~] Sections 2.101(1), 152.305, and 152.306 do not limit the effect of Subsection (a) in a limited liability partnership.

(c) For purposes of this section, [(d) In this section, “representative” includes] an obligation is incurred while a partnership is [agent, servant, or employee of] a limited liability partnership if:

(1) the obligation relates to an action or omission occurring while the partnership is a limited liability partnership; or

the partner's own tortious conduct. 2011 SB 748 also repealed TBOC § 152.804 (Insurance or Financial Responsibility) which had required LLPs to provide \$100,000 of liability insurance or a \$100,000 cash deposit, bank letter of credit or insurance company bond.

6.3.1. LLP Shield. After 2011 S.B. 748, the liability of a partner in an LLP is shielded by TBOC § 152.801 as follows, effective September 1, 2011:

Sec. 152.801. LIABILITY OF PARTNER. (a) Except as provided by the partnership agreement, a partner is not personally liable to any person, including a partner, directly or indirectly, by contribution, indemnity, or otherwise, for any obligation of the partnership incurred while the partnership is a limited liability partnership.

(b) Sections 2.101(1), 152.305, and 152.306 do not limit the effect of Subsection (a) in a limited liability partnership.

(c) For purposes of this section, an obligation is incurred while a partnership is a limited liability partnership if:

(1) the obligation relates to an action or omission occurring while the partnership is a limited liability partnership; or

(2) the obligation arises under a contract or commitment entered into while the partnership is a limited liability partnership.

(d) Subsection (a) does not affect:

(1) the liability of a partnership to pay its obligations from partnership property;

(2) the liability of a partner, if any, imposed by law or contract independently of the partner's status as a partner; or

(2) the obligation arises under a contract or commitment entered into while the partnership is a limited liability partnership.

(d) Subsection [(e) Subsections] (a) does [and (b) do] not affect:

(1) the liability of a partnership to pay its ~~debts and~~ obligations from partnership property;

(2) the liability of a partner, if any, imposed by law or contract independently of the partner's status as a partner; or

(3) the manner in which service of citation or other civil process may be served in an action against a partnership.

(e) [(f)] This section controls over the other parts of this chapter and the other partnership provisions regarding the liability of partners of a limited liability partnership, the chargeability of the partners for the ~~debts and~~ obligations of the partnership, and the obligations of the partners regarding contributions and indemnity.

(3) the manner in which service of citation or other civil process may be served in an action against a partnership.

(e) This section controls over the other parts of this chapter and the other partnership provisions regarding the liability of partners of a limited liability partnership, the chargeability of the partners for the obligations of the partnership, and the obligations of the partners regarding contributions and indemnity.¹⁴⁹⁴

6.3.2. Limits to LLP Shield. The LLP shield of TBOC § 152.801 after 2011 S.B. 748 does not protect partnership assets from claims of contract and tort creditors of the LLP.¹⁴⁹⁵ Further, the LLP Provisions do not protect a partner in an LLP from liabilities of the partner imposed by law or contract independently of the partner’s status as a partner in an LLP.¹⁴⁹⁶ A partner is always liable for the partner’s own tortious conduct.

6.3.3. Burden of Proof. The liability shield of the Tex. LLP Stats. is an affirmative defense, with the burden of proof on the partner claiming its benefit to show that the partnership is an LLP (i.e. that it complied at the relevant time(s) with the registration and name requirements). The burden would then shift to the plaintiff to prove that one or more of the three exceptions apply to remove the liability shield from particular partners.

6.3.4. LLP Status Does Not Affect Liability of Partnership. LLP status does not relieve a partnership itself from liability for misconduct of its partners or representatives or prevent its assets from being reached to satisfy partnership obligations.¹⁴⁹⁷ A partnership may still be sued as an entity in its common name under Rule 28 of the Texas Rules of Civil Procedure, with or without the partners.¹⁴⁹⁸ Citation or other process against a partnership may still be served on a partner under Section 17.022 of the Texas Civil Practice and Remedies Code, regardless of whether the partner is shielded from liability by the partnership’s LLP status.¹⁴⁹⁹

6.3.5. Shielded vs Unshielded Obligations; Time Obligations Incurred. The LLP shield only applies to the liability of partners for the partnership obligations incurred while the partnership is an LLP.¹⁵⁰⁰ For purposes of TBOC § 152.801 after 2011 S.B. 748, an obligation is incurred while a partnership is an LLP if: (i) the obligation relates to an action or omission occurring while the partnership is an LLP; or (ii) the obligation arises under a contract or commitment entered into while the partnership is an LLP.

¹⁴⁹⁴ 2011 S.B. 748 § 66 (3) repealed old TBOC § 804 which required that an LLP maintain insurance or a segregated fund of at least \$100,000 to provide for claims against the LLP.

¹⁴⁹⁵ TBOC § 152.801(d)(1) after 2011 S.B. 748.

¹⁴⁹⁶ TBOC § 152.801(d)(2) after 2011 S.B. 748.

¹⁴⁹⁷ TBOC § 152.801(d)(1) after 2011 S.B. 748 provides that the other LLP provisions do not affect “the liability of a partnership to pay its obligations from partnership property.”

¹⁴⁹⁸ TEX. R. CIV. P. 28.

¹⁴⁹⁹ TRPA § 3.08(a)(3)(C) (Vernon Supp. 2010).

¹⁵⁰⁰ See *Elmer v. Santa Fe Properties, Inc.*, 2006 WL 3612359 (Tex. – San Antonio 2006, no pet.) (under Tex. LLP Stats. in effect prior to 2011 S.B. 748, partner held liable for LLP lease obligations because it “was not a properly registered limited liability partnership when it incurred its lease obligations” because it did not have the required insurance at that time).

The partners remain jointly and severally liable for all other partnership obligations. A partnership at any time may have both shielded and unshielded obligations.

The Tex. LLP Stats. do not deal with the right of a partnership to pay unshielded obligations before paying shielded obligations or whether partner contributions may be earmarked to cover particular unshielded obligations. These matters are left to fiduciary principles and laws pertaining to creditors rights.

6.3.6. Other State LLP Statutes. In the other states that have LLP statutes, the scope of liability from which an innocent partner in an LLP is protected varies from state to state. Some LLP statutes only protect partners from vicarious liability for tort-type liabilities (“*partial shield*”), while others provide a “*full shield*” of protection from both tort and contract liabilities of the partnership,¹⁵⁰¹ perhaps in recognition that some malpractice claims could be pled in contract as well as in tort.¹⁵⁰² Under many LLP statutes, a partner is liable not only for his own negligence, malpractice, wrongful act or misconduct, but also for that of someone under his direct supervision and control. The Maryland LLP statute preserves liability for a partner who is negligent in appointing, supervising or cooperating with the partner, employee or agent who was negligent or committed the wrongful act or omission.¹⁵⁰³ At least two states, Kentucky and Utah, have adopted LLP statutes providing that a partner is personally liable only for his own negligence, malpractice, wrongful acts and misconduct.¹⁵⁰⁴

6.4. Post 2011 S.B. 748 Requirements for LLP Status. Each of the two requirements described below must be satisfied in order for the LLP shield to be in place in Texas. Creditors seeking to break the shield can be expected to require proof of satisfaction of each of the conditions and to challenge any noncompliance.

6.4.1. Name. The Tex. LLP Stats. require that an LLP must include in its name the words “limited liability partnership” or an abbreviation thereof.¹⁵⁰⁵

¹⁵⁰¹ See Bishop, *The Limited Liability Partnership Amendments to the Uniform Partnership Act (1994)*, 53 BUS. LAW. 101 (Nov. 1997), which contains a table of LLP Liability Shield Features (through October 31, 1997) showing those LLP statutes which are full shield or partial shield). See DRUPA § 15-306(c):

(c) An obligation of a partnership arising out of or related to circumstances or events occurring while the partnership is a limited liability partnership or incurred while the partnership is a limited liability partnership, whether arising in contract, tort or otherwise, is solely the obligation of the partnership. A partner is not personally liable, directly or indirectly, by way of indemnification, contribution, assessment or otherwise, for such an obligation solely by reason of being or so acting as a partner.

¹⁵⁰² Miller, *Procedural and Conflict Laws Issues Arising In Connection With Multi-State Partnerships* (ABA BUS. L. SEC. 1996 Spring Meeting).

¹⁵⁰³ MD. CORP. & ASS’N. CODE ANN. § 9A-306(d)(1) (1999).

¹⁵⁰⁴ See KY. REV. STAT. ANN. § 362.220 (Michie 2002); UTAH CODE ANN. § 48-1-12(2) (2002).

¹⁵⁰⁵ TRPA § 3.08(c); TBOC § 5.063; TEX. ADMIN. CODE tit. 1, § 80.1(b) (2003). Under the TRPA, LLPs were officially called registered limited liability partnerships. The TRPA also imposed additional restrictions regarding an LLP’s name which have been omitted from the TBOC. See Revisor’s Notes to TBOC §§ 1.002(48) and 5.063. A firm with a written partnership agreement should amend the agreement to include the required words or letters as part of its name.

6.4.2. Filing with the Secretary of State of Texas. LLPs are considered to be non-filing entities under the TBOC.¹⁵⁰⁶ Nonetheless, to achieve domestic LLP status, a partnership must file with the Secretary of State of Texas¹⁵⁰⁷ an application accompanied by a fee for each partner of \$200.¹⁵⁰⁸ The application must (a) state the name of the partnership, the address of its principal office, the number of partners and the business in which the partnership engages, plus the federal tax identification number of the partnership,¹⁵⁰⁹ and (b) be executed by a majority in interest¹⁵¹⁰ of the partners or by one or more partners authorized by a majority in interest of the partners. The Tex. LLP Stats. do not require that an LLP filing with the Secretary of State have any express authorization in the partnership agreement, but changing the name to include the required words or abbreviation required by Tex. LLP Stats. would ordinarily require that the partnership agreement contemplate LLP status.¹⁵¹¹

If the required information is supplied in the application and the fee is paid, the LLP registration becomes effective upon filing.¹⁵¹² There is no requirement for the Secretary of State

Compliance with the Texas name requirements by a law firm should not conflict with the misleading name prohibition in Rule 7.01 of Texas Disciplinary Rules of Professional Conduct, which provides in relevant part as follows:

(a) A lawyer in private practice shall not practice under a trade name, a name that is misleading as to the identity of the lawyer or lawyers practicing under such name, or a firm name containing names other than those of one or more of the lawyers in the firm, except that the names of a professional corporation or professional association may contain "P.C." or "P.A." or similar symbols indicating the nature of the organization . . .

[emphasis added]. The underscored language was in Rule 7.04 before LLPs were authorized and was intended to clarify that it is permissible to include in a firm name words, initials or symbols indicating the nature of the limited liability form of organization. The references to "professional corporation," "professional association," "P.C." and "P.A." are by way of example and not limitation, and they do not limit the use of the words or letters "registered limited liability partnership" or "L.L.P." in a firm name. The legislative history of the LLP Provisions clearly shows that the legislature intended the LLP form of business organization to be available to firms of lawyers and other professionals.

1506 See TBOC §§ 1.002(57), (34).

1507 The rules of the Secretary of State dealing with LLP filings may be found at TEX. ADMIN. CODE tit. 1, §§ 80.1-80.7 (2003) as well as TRPA § 3.08(b) and TBOC § 152.802.

1508 The \$200 per partner fee for LLPs organizing under Texas law is based on the total partners in the firm, and not the number of partners in Texas, under TRPA § 3.08(b)(3) and TBOC § 4.158(1). For a foreign LLP, the fee is \$200 per partner in Texas, not to exceed \$750, under TRPA § 10.02(c) and TBOC § 4.158(1).

1509 The Secretary of State's form of application and the Tex. LLP Stats. require the tax identification number of the partnership as part of the application to provide more positive identification than the partnership name, which may change or may be similar to other names.

1510 "Majority in interest" is defined in TRPA § 1.01(10), TRLPA § 1.02(7), and TBOC § 151.001(3) as more than 50% of the current interest in profits of the partnership. Although not required by the Secretary of State's form or the Tex. LLP Stats., it is prudent for an application to recite that it is signed by a majority in interest of the partners or by one or more partners authorized by a majority in interest of the partners.

1511 In some states, electing LLP status requires unanimous partner approval or an amendment to the partnership agreement in accordance with the applicable partnership agreement provisions. See Bishop, *The Limited Liability Partnership Amendments to the Uniform Partnership Act (1994)*, 53 BUS. LAW. 101, 114-115 (Nov. 1997).

1512 TBOC § 4.051. The Secretary of State must register or renew as an LLP any partnership that submits a completed application with the required fee. See Tex. Admin. Code tit. 1, § 80.3 (2008); TBOC § 4.002.

to issue a certificate. As evidence of the filing, the Secretary of State will return a file-stamped duplicate of the application. The Tex. LLP Stats. now permit electronic filings of LLP documents as soon as the Secretary of State’s procedures will permit.¹⁵¹³

Registration remains effective for a year,¹⁵¹⁴ regardless of changes in the partnership, unless the registration is earlier withdrawn or revoked or unless renewed.¹⁵¹⁵ Because the registration is a notice filing and no listing of partners is required in the application, partnership changes due to withdrawals or to admissions of new partners do not require any re-filing with the Secretary of State until the next renewal filing.¹⁵¹⁶ Caution suggests an amendment to the application if the partnership changes its name. LLPs should arrange their own reminders, since the Secretary of State is not obliged to send renewal notices.

6.5. Other Issues.

6.5.1. Advertisement of LLP Status. Although the LLP designation must be part of an LLP’s name and should be used as such, it is common and permissible for some LLP communications and signage to be shorthanded and omit the designation. A rule of reason should apply in deciding how far a partnership should go in omitting the LLP designation in communications. When an existing partnership elects to become an LLP, it should have a reasonable period of time in which to implement the use of the LLP status words or symbols in printed matter and should be able to use up existing supplies of letterhead, etc.

There is no requirement, beyond the name change, that a partnership that becomes an LLP notify its customers, clients or patients of the partnership’s new status. Further, there is no requirement that a partnership publish notice of its becoming an LLP comparable to the notice required of incorporations in certain other states.¹⁵¹⁷

6.5.2. Assumed Name Certificate. Like other Texas business entities, an LLP may transact business in Texas under another name by filing an assumed name certificate under the Texas Assumed Business or Professional Name Act (the “Assumed Name Statute”).¹⁵¹⁸ LLPs, like LLCs and limited partnerships, are not deemed to be conducting business under an “assumed name,” and do not have to make filings under the Assumed Name Statute, if they conduct business in the same name as shown in their documents on file in the office of the Secretary of State.¹⁵¹⁹ However, a general partnership which is not an LLP would have to file under the Assumed Name Statute if it conducted business under a name that does not include the surname or legal name of each general partner.¹⁵²⁰ If an LLP, LLC or limited partnership regularly conducts business under any other name (an “assumed name”), it would be required to file in the

¹⁵¹³ TRPA § 3.08(b)(16); TBOC § 4.001(a)(2).

¹⁵¹⁴ TRPA § 3.08(b)(5); TBOC § 152.802(e).

¹⁵¹⁵ TRPA §§ 3.08(b)(6), (7); TBOC § 152.802(e).

¹⁵¹⁶ See TBOC § 152.802(d); TRLPA § 3.08(b)(4); TEX. ADMIN. CODE tit. 1, §§ 80.1, 80.4 (2015).

¹⁵¹⁷ The New York LLP statute requires publication of a notice once per week for six weeks upon creation of an LLP. N.Y. Partnership Law § 121-1500(a)(11)(A) (McKinney Supp. 2015).

¹⁵¹⁸ Tex. Bus. & Com. Code § 71.001 *et seq.* (West 2015).

¹⁵¹⁹ TEX. BUS. & COM. CODE § 71.002(2)(G).

¹⁵²⁰ TEX. BUS. & COM. CODE § 71.051.

office of the county clerk of each county in which it maintains a business or professional premises a certificate setting forth the assumed name of the firm and the name and residence address of each general partner.¹⁵²¹ Failure to comply with the filing requirements of the Assumed Name Statute should not affect the partnership's LLP status, but would subject the partnership to the penalties specified in the Assumed Name Statute.¹⁵²² Under the Assumed Name Statute it would be possible for an LLP to adopt an assumed name that did not include the LLP designation.

6.5.3. Time of Compliance. A partnership must be in compliance with the Tex. LLP Stats. requirements for an LLP at the time of misconduct giving rise to an obligation in order to raise the liability shield. Texas law expressly states that the shielded partners are not liable for misconduct incurred while the partnership is an LLP.¹⁵²³

The liabilities of a general partnership that incorporates or becomes a limited partnership remain the individual liabilities of the former general partners notwithstanding the assumption of those liabilities by the new entity.¹⁵²⁴ Likewise, dissolution of a corporation or limited partnership does not result in the liability of its shareholders or limited partners for the entity's obligations,¹⁵²⁵ and the result should be no different in the case of the dissolution of an LLP. Thus, for example, if an LLP were to dissolve, its partners should not lose the liability shield in an action brought during winding up for misconduct that occurred, or upon a contract made, before dissolution.

6.5.4. Effect on Pre-LLP Liabilities. An LLP is the same partnership that existed before it became an LLP.¹⁵²⁶ Since the Tex. LLP Stats. shield protects partners only against liabilities incurred while the partnership is an LLP, attainment of LLP status has no effect on pre-existing partnership liabilities. In *Medical Designs, Inc. v. Shannon, Gracey, Ratliff & Miller, L.L.P.*,¹⁵²⁷ a law firm was sued for malpractice and obtained a summary judgment that was upheld on appeal on the basis that a "successor partnership" is *not liable* for the torts of a predecessor partnership, although the liabilities of the prior partners would remain their liabilities. The law firm defendant had, subsequent to the time the alleged malpractice occurred, merged and unmerged with another law firm, and the miscreant partner of the prior partnership was not associated with the defendant law firm. Under these facts the court of appeals wrote, "Texas does not recognize that successor partnerships are liable for the tortious conduct of predecessor

¹⁵²¹ TEX. BUS. & COM. CODE § 71.054.

¹⁵²² TEX. BUS. & COM. CODE §§ 71.201, 71.202 and 71.203.

¹⁵²³ TBOC § 152.801(a); *see also* TRPA § 3.08(a)(1). This result is buttressed by the Bar Committee Bill Analysis of 1994 H.B. 273 which at 14 states that TRPA § 3.08(a)(1) "clarifies that the partnership must be a registered limited liability partnership at the time of the errors and omissions for which partner liability is limited."

¹⁵²⁴ *See* TBOC § 153.505(a); TRPA § 7.03(a); *see also* *Baca v. Weldon*, 230 S.W.2d 552 (Tex. Civ. App.—San Antonio, 1950, writ ref'd n.r.e.).

¹⁵²⁵ *See* *Hunter v. Fort Worth Capital Corp.*, 620 S.W.2d 547 (Tex. 1981); *Anderson v. Hodge Boats & Motors, Inc.*, 814 S.W.2d 894 (Tex. App.—Beaumont 1991).

¹⁵²⁶ *See* *Middlemist v. BDO Seidman, LLP*, 958 P.2d 486 (Colo. Ct. App. 1997); *Sasaki v. McKinnon*, 707 N.E. 2d 9 (Ohio Ct. App. 1997); and *Howard v. Klynveld Peat Marwick Goerdeler*, 977 F. Supp. 654 (S.D. N.Y. 1997).

¹⁵²⁷ 922 S.W.2d 626 (Tex. App.—Fort Worth 1996, writ denied).

partnerships.”¹⁵²⁸ However, there is nothing in the court’s opinion suggesting that registration as an LLP is enough to make the partnership a different partnership.¹⁵²⁹

6.5.5. Limited Partnership as LLP. A limited partnership can become an LLP simply by complying with the applicable LLP provisions, in which case it would be a “LLL.”¹⁵³⁰ In addition, Tex. LLP Stats. provide that a limited partnership is an LLP as well as a limited partnership if it (i) registers as an LLP under the proper provisions,¹⁵³¹ as permitted by its partnership agreement or with the consent of partners required to amend its partnership agreement to so permit, and (ii) contains in its name¹⁵³² “limited liability partnership,” “limited liability limited partnership” or an abbreviation thereof.¹⁵³³

In an LLLP the general partners should have the same liability shield as partners in any other LLP. In a limited partnership, a limited partner is not liable to creditors unless (i) the limited partner participates in the control of the business and (ii) the creditor reasonably believed that the limited partner was a general partner.¹⁵³⁴ Under the Tex. LLP Stats., a limited partner in an LLLP whose conduct would otherwise render it liable as a general partner has the benefit of the LLP shield.¹⁵³⁵

6.5.6. Indemnification and Contribution. The Tex. LLP Stats. eliminate the usual right of a partner who is held personally liable for a partnership obligation to obtain indemnification from the partnership or contribution from co-partners.¹⁵³⁶ It seems inconsistent with the Tex. LLP Stats. to allow a partner to recover, directly or indirectly, from co-partners who are shielded from liability by the same statutes, absent a specific agreement of indemnification.¹⁵³⁷ Indeed, TBOC § 152.801 and TRPA § 3.08(a) expressly provide that a partner is not individually liable “by contribution, indemnity, or otherwise” for partnership obligations except as otherwise provided. Quite apart from the Tex. LLP Stats., there is authority that a partner who commits malpractice cannot recover from his or her non-negligent copartners.¹⁵³⁸ It would certainly be inconsistent

¹⁵²⁸ *Id.* at 629.

¹⁵²⁹ For an analysis of the *Shannon Gracey* case, see Elizabeth S. Miller, *The Advent of LLCs and LLPs in the Case Law: A Survey of Cases Dealing With Registered Limited Liability Partnerships and Limited Liability Companies* presented at symposium on Partnerships and LLCs - Important Case Law Developments 1998 at ABA Annual Meeting in Toronto, Ontario, Canada on August 4, 1998.

¹⁵³⁰ See TBOC §§ 152.805, 1.002(47); TRPA § 3.08(e).

¹⁵³¹ TBOC § 152.802; TRPA § 3.08(b).

¹⁵³² TBOC § 5.055(b).

¹⁵³³ TBOC § 153.351; TRLPA § 2.14.

¹⁵³⁴ TBOC § 153.102; TRLPA § 3.03.

¹⁵³⁵ TBOC § 153.353; TRLPA § 2.14(c).

¹⁵³⁶ TBOC § 152.801; TRPA § 3.08.

¹⁵³⁷ See *Henry v. Masson*, 333 S.W.3d 825 (Tex. App.—Houston [1st Dist.] 2010, no pet.), in which the Court held that the partnership agreement, which provided that if no partner agreed to lend funds needed to discharge the partnership’s debts, obligations and liabilities as they came due, each partner was required to timely contribute the partner’s proportionate share of funds needed applied in the winding up process and was not inconsistent with the LLP Provisions in TRPA.

¹⁵³⁸ See, e.g., *Flynn v. Reaves*, 218 S.E.2d 661 (Ga. App. 1975).

with the Tex. LLP Stats. to let a plaintiff reach those co-partners through some theory of subrogation based on an alleged indemnification or contribution right of the misfeasant partner.

6.5.7. Inconsistent Partnership Agreement Provisions. A written or oral partnership agreement can modify or defeat the LLP liability shield. In cases where a partnership agreement sets forth partner indemnification or contribution obligations inconsistent with those described above,¹⁵³⁹ a creditor could argue that the partnership agreement supersedes the shield afforded by the Tex. LLP Stats.¹⁵⁴⁰ Thus, if a miscreant partner is entitled to indemnification from the innocent partners in excess of the firm's assets, then a creditor could claim the indemnification right has become an asset of the miscreant partner's bankruptcy estate and the indemnification agreement could lead to a series of payments from the innocent partners, with each payment ultimately being for the benefit of creditors entitled to recover for the actions of the miscreant partner.¹⁵⁴¹ The LLP could counter that compliance with the Tex. LLP Stats. amends or otherwise trumps any inconsistent partnership agreement provisions. Attorneys should exercise care to assure that the partnership agreement of an LLP does not contain indemnification or contribution provisions that would inadvertently frustrate the LLP purpose.

Since a partnership agreement may be written or oral,¹⁵⁴² an LLP should have a written partnership agreement that provides that it may be amended only by a written amendment. Otherwise a creditor might argue that partner contributions to pay unshielded obligations (e.g.,

¹⁵³⁹ Any LLP that intends by contract to require partners whose liabilities are shielded by the Tex. LLP Stats. to indemnify or contribute to partners whose liability is not shielded (due to their own misconduct) should be particularly sensitive to the "express negligence doctrine." Under the "express negligence doctrine" as articulated by the Supreme Court of Texas, an indemnification agreement is not enforceable to indemnify a party from the consequences of its own negligence unless such intent is specifically stated in the agreement. *See Ethyl Corp. v. Daniel Constr. Co.*, 725 S.W.2d 705, 708 (Tex. 1987), wherein the Supreme Court held:

The express negligence doctrine provides that parties seeking to indemnify the indemnitee from the consequences of its own negligence must express that intent in specific terms. Under the doctrine of express negligence, the intent of the parties must be specifically stated within the four corners of the contract. We now reject the clear and unequivocal test in favor of the express negligence doctrine. In so doing, we overrule [prior decisions] stating it is unnecessary for the parties to say, 'in so many words,' they intend to indemnify the indemnitee from liability for its own negligence.

* * *

The contract between Daniel and Ethyl speaks to 'any loss . . . as a result of operations growing out of the performance of this contract and caused by the negligence or carelessness of [Daniel]. . . .' Ethyl emphasizes the 'any loss' and 'as a result of operations' language to argue an intent to cover its own negligence. We do not find such meaning in those words. The indemnity provision in question fails to meet the express negligence test.

See also Dresser Industries, Inc. v. Page Petroleum, Inc., 853 S.W.2d 505 (Tex. 1993); *Atlantic Richfield Co. v. Petroleum Personnel, Inc.*, 768 S.W.2d 724 (Tex. 1989).

¹⁵⁴⁰ Bishop, *The Limited Liability Partnership Amendments to the Uniform Partnership Act (1994)*, 53 BUS. LAW. 101, 118-120 (Nov. 1997).

¹⁵⁴¹ *See Banoff, Alphabet Soup: A Navigator's Guide*, 4 BUS. L. TODAY 10, 12 (March/April 1995).

¹⁵⁴² TRPA § 1.01(12); TBOC § 151.001(4).

rent on a lease executed before September 1, 1997) constituted an amendment by conduct to the partnership agreement that dropped the LLP liability shield.¹⁵⁴³

6.5.8. Fiduciary Duties. Partners in an LLP are in a fiduciary relationship and owe each other fiduciary duties just as in any other partnership. In *Sterquell v. Archer*,¹⁵⁴⁴ the court wrote:

No one disputed that Archer, Sterquell, and Harris were partners. As such, they were involved in a fiduciary relationship which obligated each to act loyally towards one another and to fully disclose information affecting the partnership and their interests in same. [Citations omitted] So too were each prohibited from personally taking advantage of information unknown to the others but concerning partnership interests. *Id.* (each is a confidential agent of the other, each has a right to know all that the others know). Furthermore, in violating any of these fiduciary duties, the actor committed fraud. [Citations omitted]

6.5.9. Foreign LLP Qualification. A foreign LLP doing business in Texas¹⁵⁴⁵ may qualify to do business in Texas like a foreign LLC¹⁵⁴⁶ (the filing fee would be the lesser of \$200 per resident

¹⁵⁴³ Bishop, *The Limited Liability Partnership Amendments to the Uniform Partnership Act (1994)*, 53 BUS. LAW. 101, 120 (Nov. 1997).

¹⁵⁴⁴ No. 07-96-0218-CV, 1997 WL 20881, at *6 (Tex. App.—Amarillo 1997, writ denied).

¹⁵⁴⁵ Texas law does not define what constitutes “transacting business in Texas” for the purposes of the requirement of TBOC § 152.905 (and the substantially similar TRPA § 10.02(a)) that “[b]efore transacting business in this state, a foreign limited liability partnership must file an application for registration in accordance with this section and Chapters 4 and 9.” TBOC § 9.251, however, does contain the following non-exclusive list of activities not constituting transacting business in Texas:

Sec. 9.251. Activities Not Constituting Transacting Business In This State.

For purposes of this chapter, activities that do not constitute transaction of business in this state include:

- (1) maintaining or defending an action or suit or an administrative or arbitration proceeding, or effecting the settlement of:
 - (A) such an action, suit, or proceeding; or
 - (B) a claim or dispute to which the entity is a party;
- (2) holding a meeting of the entity’s managerial officials, owners, or members or carrying on another activity concerning the entity’s internal affairs;
- (3) maintaining a bank account;
- (4) maintaining an office or agency for:
 - (A) transferring, exchanging, or registering securities the entity issues; or
 - (B) appointing or maintaining a trustee or depository related to the entity’s securities;
- (5) voting the interest of an entity the foreign entity has acquired;
- (6) effecting a sale through an independent contractor;
- (7) creating, as borrower or lender, or acquiring indebtedness or a mortgage or other security interest in real or personal property;

partner¹⁵⁴⁷ or \$750); however, the failure of the foreign LLP to qualify would not affect its LLP shield in Texas.¹⁵⁴⁸ Under the Tex. LLP Stats., the laws of the state under which a foreign LLP

- (8) securing or collecting a debt due the entity or enforcing a right in property that secures a debt due the entity;
- (9) transacting business in interstate commerce;
- (10) conducting an isolated transaction that:
 - (A) is completed within a period of 30 days; and
 - (B) is not in the course of a number of repeated, similar transactions;
- (11) in a case that does not involve an activity that would constitute the transaction of business in this state if the activity were one of a foreign entity acting in its own right:
 - (A) exercising a power of executor or administrator of the estate of a nonresident decedent under ancillary letters issued by a court of this state; or
 - (B) exercising a power of a trustee under the will of a nonresident decedent, or under a trust created by one or more nonresidents of this state, or by one or more foreign entities;
- (12) regarding a debt secured by a mortgage or lien on real or personal property in this state:
 - (A) acquiring the debt in a transaction outside this state or in interstate commerce;
 - (B) collecting or adjusting a principal or interest payment on the debt;
 - (C) enforcing or adjusting a right or property securing the debt;
 - (D) taking an action necessary to preserve and protect the interest of the mortgagee in the security; or
 - (E) engaging in any combination of transactions described by this subdivision;
- (13) investing in or acquiring, in a transaction outside of this state, a royalty or other non-operating mineral interest; or
- (14) the execution of a division order, contract of sale, or other instrument incidental to ownership of a non-operating mineral interest.

See also TBOC § 153.903. The TRPA § 10.04 provided substantially the same.

¹⁵⁴⁶ *See* TRPA article X; TBOC Chapter 9 and §§ 152.901-152.914 and 402.001(e).

¹⁵⁴⁷ The Secretary of State has adopted a regulation for determining whether a partner is in Texas for purposes of annual fee calculations. Texas Administrative Code title 1, § 80.2(f) provides as follows:

- (f) *Partners in Texas.* For purposes of this section, a partner is considered to be in Texas if:
- (1) the partner is a resident of the state;
 - (2) the partner is domiciled or located in the state;
 - (3) the partner is licensed or otherwise legally authorized to perform the services of the partnership in this state; or

is formed will govern its organization and internal affairs and the liability of partners for obligations of the partnership.¹⁵⁴⁹

Thus, under the Tex. LLP Stats., partners may choose the state law, and hence the liability shield, that they wish to apply to their relationship.¹⁵⁵⁰ That choice should not be subject to the general limitation in the Tex. GP Stats. that the law chosen by the partners to govern binds only “if that state bears a reasonable relation to the partners or to the partnership business and affairs under principles that apply to a contract among the partners other than the partnership agreement.”¹⁵⁵¹

A determination of whether a foreign LLP must qualify to do business in any particular state must be made on a state by state basis. A number of states, such as Delaware,¹⁵⁵² do not require such qualification, but recognize that the law governing the internal affairs of a partnership also governs its liability to third parties. By contrast, New York and Maryland require foreign LLPs to qualify to do business in the state.¹⁵⁵³

6.5.10. Bankruptcy. Section 723 of the Bankruptcy Code¹⁵⁵⁴ addresses the personal liability of general partners for the debts of the partnership, granting the trustee a claim against “any general partner” for the full partnership deficiency owing to creditors to the extent that the partner would be personally liable for claims against the partnership. In recognition of uncertainty as to how this provision would be construed to apply with regard to LLPs which had been authorized by a number of states since the advent of the 1978 Bankruptcy Code, the 1994 amendments to the Bankruptcy Code clarified that a partner of an LLP would only be liable in bankruptcy to the extent that the partner would be personally liable for a deficiency according to the LLP statute under which the partnership was formed.¹⁵⁵⁵

6.5.11. Federal Diversity Jurisdiction. An LLP is a citizen of every state in which one of its partners resides for the purposes of Federal court diversity jurisdiction.¹⁵⁵⁶ As a result, large

(4) the partner, or a representative of the partnership working under the direct supervision or control of the partner, will be providing services or otherwise transacting the business of the partnership within the state for a period of more than 30 days.

1548 TRPA § 10.03(c); TBOC §§ 9.051, 152.910.

1549 The TBOC places governance by foreign law into the very definition of “foreign”: “‘Foreign’ means, with respect to an entity, that the entity is formed under, and the entity’s internal affairs are governed by, the laws of a jurisdiction other than this state.” TBOC § 1.002(27). *See also* TBOC § 1.103. TRPA § 10.01 similarly recognizes foreign governance of a foreign LLP’s internal affairs.

1550 TRPA § 10.01; TBOC §§ 1.101-1.105.

1551 TBOC § 1.002(43)(C)(i), providing substantively the same. *See also* Tex. Bus. & Com. Code § 271.004.

1552 DEL. CODE ANN., tit. 6, §§ 15-1001–15-1004.

1553 N.Y. P’SHP LAW § 121-1502 (McKinney Supp. 2006); MD. CODE ANN. CORPS. & ASS’NS § 9A-1101 (1999).

1554 11 U.S.C. § 723, as amended by Pub.L. 103-394, Title II, § 212, Oct. 22, 1994, 108 Stat. 4125 (the “Bankruptcy Code”).

1555 Congressional Record—House H 10767 (Oct. 4, 1994). This amendment to the Bankruptcy Code is attributable in large part to efforts of representatives of the Texas Business Law Foundation.

1556 *Reisman v. KPMG Peat Marwick LLP*, 965 F. Supp. 165 (D. Mass. 1997), relying on *Carden v. Arkoma Assoc.*, 494 U.S. 185 (1990).

accounting firms with offices in most states are likely beyond the reach of the diversity jurisdiction of the Federal courts.¹⁵⁵⁷

CHAPTER 7. EXTRATERRITORIAL RECOGNITION OF LLC AND LLP LIMITED LIABILITY.

7.1. General. Courts of other states should recognize the Texas statutory liability shield of LLCs and LLPs under the “internal affairs” doctrine, which treats the laws of the state of organization as governing the liability of members of business organizations, such as corporations and limited partnerships.¹⁵⁵⁸ The principal case that did not follow this doctrine was a 1938 Texas case,¹⁵⁵⁹ which has been legislatively repudiated by the TBOC which codifies the internal affairs doctrine.¹⁵⁶⁰ The extent to which LLC or LLP status will be recognized in other jurisdictions absent a specific statute, however, remains a question for which there is little case-law precedent.¹⁵⁶¹

7.2. Texas Statutes. The LLC Act states that it is the “intention of the legislature by the enactment of this Act that the legal existence of limited liability companies formed under this Act be recognized beyond the limits of this state and that, subject to any reasonable registration requirements, any such limited liability company transacting business outside this state shall be granted the protection of full faith and credit under Section 1 of Article IV of the Constitution of the United States.”¹⁵⁶²

There is no comparable statement of legislative intention in the Tex. LLP Stats. However, they do provide that (1) a partnership’s internal affairs are governed by the law of the state chosen by the partners if the law chosen bears a reasonable relationship to the partnership’s business and affairs under applicable choice of law principles and (2) the law governing a partnership’s internal affairs also governs the liability of its partners to third parties.¹⁵⁶³ Texas has thus codified the internal affairs doctrine recognized by the courts of other states, as discussed below.

¹⁵⁵⁷ The court in *Reisman* wrote that it was “particularly troubled that a Big Six accounting firm which operates offices within every state in the United States has effectively immunized itself from the reach of the diversity jurisdiction of the federal courts simply by organizing itself as a limited liability partnership rather than a corporation. Nevertheless, until Congress addresses the jurisdictional implications of this new class of business entities, this Court can reach no other result.”

¹⁵⁵⁸ TBOC § 1.101-1.105; *cf.* Revised Uniform Limited Partnership Act § 9.01 adopted in many states and in this state as TRLPA § 9.01(a); TBCA art. 8.02; 59A Am. Jur. 2d Partnership § 30 (1987); 29 A.L.R. 2d 295 (1953). For a discussion of the history of TBCA art. 8.02, see R. Dennis Anderson and Harva R. Dockery, *Formalities of Corporate Operations*, Texas Corporations—Law and Practice § 31.05 (1986).

¹⁵⁵⁹ *Means v. Limpia Royalties*, 115 S.W.2d 468 (Tex. Civ. App.—Ft. Worth 1938, writ *dism’d*).

¹⁵⁶⁰ See TBOC §§ 1.101-1.105.

¹⁵⁶¹ See Herbert B. Chermiside, Jr., Annotation, *Modern Status of the Massachusetts or Business Trust*, 88 A.L.R. 3d 704 (1978) (“In some jurisdictions a Massachusetts or business trust has been treated as a partnership for some purposes.”).

¹⁵⁶² LLC Act § 4.03B.

¹⁵⁶³ TRPA § 1.05; TBOC §§ 1.101-1.105.

7.3. Texas Cases. Texas appears to be the only state with a reported decision denying limited liability to owners of an unincorporated entity formed under another state’s law because the forum state did not have such a statute.¹⁵⁶⁴ In *Means v. Limpia Royalties*,¹⁵⁶⁵ suit was brought in Texas by a purchaser of trust interests for rescission of the purchase because of misrepresentations by the defendant that holders of trust interests could not be liable for trust obligations. Limpia Royalties was an unincorporated association operating under a declaration of trust, was organized under the laws of Oklahoma and had its principal office in Oklahoma. In holding that the representations were materially misleading, the court wrote:

It is well settled in this state by a long line of decisions that a shareholder in an unincorporated or joint-stock association is liable to its creditor for debts of the association; his liability being that of a partner. 25 Tex. Jur. section 20, p. 202, and authorities there cited.

The fact that, under the laws of the state of Oklahoma and under the provisions of the declaration of trust, a shareholder in the Limpia Royalties could not be held liable for the debts or obligations of the association would not operate to extend the same immunity from liability growing out of transactions by the association in the state of Texas, since, as is well said in the opinion in *Ayub v. Automobile Mortgage Company*, 252 S.W. 287, 290 [(Tex. Civ. App.—El Paso 1923, writ granted) *rev’d. Auto. Mortgage Co. v. Ayub*, 266 S.W. 134 (Tex. Comm’n. App. 1924)]. “The established public policy of the forum is supreme, and will not be relaxed upon the ground of comity to enforce contracts which contravene such policy, even though such contracts are valid where made.”¹⁵⁶⁶

¹⁵⁶⁴ Commentators generally suggest that uncertainty as to whether the statutory limited liability of Members will be recognized in a jurisdiction other than the jurisdiction of the LLC’s organization is a drawback to using an LLC for a business with operations in more than one state, but the only authorities cited for that concern are the Texas cases discussed herein. See, e.g., Lederman, *Miami Device: The Florida Limited Liability Company*, 67 TAXES 339, 342 (June 1989); and Roche, Keatinge and Spudis, *Limited Liability Companies Offer Pass-Through Benefits Without S Corp. Restrictions*, 74 J. TAX’N 248, 253 (April 1991).

¹⁵⁶⁵ 115 S.W.2d 468, 475 (Tex. Civ. App.—Ft. Worth 1938, writ *dism’d*).

¹⁵⁶⁶ 115 S.W.2d at 475. The *Limpia Royalties* case was cited and its rationale followed in *Cherokee Village v. Henderson*, 538 S.W.2d 169, 173 (Tex. Civ. App.—Houston 1976, writ *dism’d*), a personal injury case in which the property on which the injury occurred was held pursuant to a trust agreement. The trust agreement, which apparently was governed by Texas law, recited that no partnership was intended and that no party had any right to incur any liability on account of any other party. The defendants in the case were holders of beneficial interests in the trust, which was a successor to a general partnership in which the holders had been partners. Two years after the creation of the trust, but two years prior to the injury, three individuals withdrew from the arrangement by a document which purported to be an amendment to the venture’s “agreement of general partnership” and an assumed name certificate was filed in which the defendants were listed as general partners. The court was not persuaded by the defendants’ testimony that these actions were erroneous. In holding that the defendants were liable and that the trust was a partnership under Texas law, the court wrote:

Article 6132b, the Texas Uniform Partnership Act, Section 6, defines a partnership as “an association of two or more persons to carry on as co-owners a business for profit.” Section 7 of this Act sets forth certain criteria for determining the existence of a partnership under the Act. Under this section it is provided that with the exception of certain circumstances not here existent, the receipt by a person of a share of the profits of a business is *prima facie* evidence that he is a partner of the business. TEX. REV. CIV. STAT. ANN. art. 6132a, the Texas

The sections of the Tex. LLC Stats. providing for qualification of Foreign LLCs were intended to repudiate, and resolve the concern raised by, the *Limpia Royalties* case with respect to limited liability of non-corporate entities created under the laws of other states but not authorized to be created under Texas law.¹⁵⁶⁷ The Bill Analysis¹⁵⁶⁸ used by the Legislature in connection with the consideration of 1991 H.B. 278 states:

The provisions of Part 7 providing for the qualification of foreign Limited Liability Companies is intended to eliminate the concern raised by *Means v. Olympia [sic] Royalties*, 115 S.W.2d 468 (Tex. Civ. App.—Ft. Worth 1938 [writ dism'd]), as to whether a Texas court would honor the limitation of liability of a foreign business entity. Moreover, the definition of “Foreign Limited Liability Company” is sufficiently broad to provide for the qualification of any business entity affording limited liability, not entitled to qualify under another statute, whether or not characterized as a limited liability company.¹⁵⁶⁹

Uniform Limited Partnership Act, sets forth the method by which limited partners, who do not wish to be bound by the obligations of the partnership, may carry on a business as a limited partnership. TEX. REV. CIV. STAT. ANN. art. 6138a sets forth the requirements for creation of a Real Estate Investment Trust. Section 8 of that Act provides for limited liability of the shareholders of such a trust. Appellants here do not contend that there was compliance with the requisites of either of these statutes.

Where two or more persons associate themselves as co-owners of a business for profit they become jointly and severally responsible for obligations incurred in the conduct of such business unless they have established, under some applicable statute, an association which the law recognizes as providing limited personal liability.

¹⁵⁶⁷ 1991 H.B. 278 § 46 Part Seven. Prior to the enactment of 1991 H.B. 278, Texas was already firmly committed by statute to the internal affairs doctrine for both corporate and non-corporate business organizations. The 1977 amendment to Texas Uniform Limited Partnership Act, art. 6132a § 32(c) specified that, in the case of a foreign limited partnership qualified in Texas, “its internal affairs and the liability of its limited partners shall be governed by the laws of the jurisdiction of its formation.” That principle is carried forward in Texas Revised Limited Partnership Act, article 6132a-1 § 9.01(a): “The laws of the state under which a foreign limited partnership is formed govern its organization and internal affairs and the liability of its partners” (whether or not the foreign limited partnership is registered to do business in Texas). The 1989 amendment to TBCA prescribes that “only the laws of the jurisdiction of incorporation of a foreign corporation shall govern (1) the internal affairs of the foreign corporation . . . and (2) the liability, if any, of shareholders . . .” The TBOC provides substantively the same. TBOC §§ 1.002(27), (28), 1.102-1.105.

¹⁵⁶⁸ Bill Analysis of H.B. 278 by Wolens at 10 (1991). See 1991 Bill Analysis Summary at 41.

¹⁵⁶⁹ “Foreign Limited Liability Company” is broadly defined in LLC Act § 1.02(9) as follows:

(9) “Foreign Limited Liability Company” means an entity formed under the laws of a jurisdiction other than this state (a) that is characterized as a limited liability company by such laws or (b) although not so characterized by such laws, that elects to procure a certificate of authority pursuant to Article 7.01 of this act, that is formed under laws which provides [sic] that some or all of the persons entitled to receive a distribution of the assets thereof upon the entity’s dissolution or otherwise or to exercise voting rights with respect to an interest in the entity shall not be liable for the debts, obligations or liabilities of the entity and which is not authorized to qualify to do business in this state under any other statute.

See also *supra* notes 1436-1443 and related text and TBOC §§ 9.001-9.003.

1991 H.B. 278 § 46 art. 7.02 provides in relevant part as follows with respect to a foreign limited liability company that has procured a certificate of authority from the Secretary of State to transact business in Texas pursuant to 1991 H.B. 278 § 46 Part Seven:

7.4. Decisions in Other States. There is precedent in other jurisdictions suggesting that their courts would apply the internal affairs doctrine to unincorporated entities not organized or qualified to do business as foreign entities under local law, thus preserving the liability shield of Texas law for LLCs and LLPs. Further, there apparently are no reported cases in other jurisdictions that follow the reasoning of, or reach the same result as, the *Limpia Royalties* case.

This issue of which jurisdiction's law governs liabilities of partners to third parties arose in *King v. Sarria*, an 1877 New York case of first impression.¹⁵⁷⁰ The defendants entered into a contract of partnership in Cuba, which was then ruled by Spanish law. Under the contract, defendant Sarria became a special partner whose liability was expressly limited to a fixed amount. As a special partner under Spanish law, Sarria was entitled to participate in the profits of the partnership, but could not be made liable for its debts. The plaintiffs sought to recover from Sarria a sum of money due under a contract with the partnership.

The court held that the partnership agreement was governed by the laws of Spain¹⁵⁷¹ and that the liability of Sarria and the extent of the authority of his partners to bind him¹⁵⁷² were to be determined by those laws. The court stated:

. . . only the laws of the jurisdiction of organization of a foreign limited liability company shall govern (1) the internal affairs of the foreign limited liability company, including but not limited to the rights, powers, and duties of its manager and members and matters relating to its ownership, and (2) the liability, if any, of members of the foreign limited liability company for the debts, liabilities and obligations of the foreign limited liability company for which they are not otherwise liable by statute or agreement.

See also TBOC §§ 1.104 and 1.105.

¹⁵⁷⁰ *King v. Sarria*, 69 N.Y. 24 (N.Y. Ct. App. 1877).

¹⁵⁷¹ Where a partnership is formed under the laws of a particular state and there is no conflicting choice of law provision in the agreement, it is as if the partners have implicitly agreed to be bound by the laws of that state. See *Rogers v. Guaranty Trust*, 288 U.S. 123 (1933); *Seidman & Seidman v. Wolfson*, 123 Cal. Rptr. 873 (Cal. Ct. App. 1975) (California court held that New York law should determine the rights and obligations among partners in an accounting firm where the partnership agreement so provided); *Hill-Davis Co. v. Atwell*, 10 P.2d 463 (Cal. 1932) (a court will generally refer to the law of the state of the entity's organization to determine the precise nature of the powers or qualities enjoyed by such entity); *Gilman Paint & Varnish v. Legum*, 80 A.2d 906, 29 A.L.R. 2d 236 (Md. 1951) (the liability to third persons of a partner with limited liability is an issue to be determined under Maryland law where the partners were all from Maryland, the partnership agreement was made in Maryland, it was a Maryland partnership in its inception and no representations were made otherwise); *Froelich & Kuttner v. Sutherland*, 22 F.2d 870 (D.C. 1927) (where entity was organized under Philippine statutes, that country's laws determined whether the organization was a general partnership, limited partnership or a corporation).

¹⁵⁷² The court in *King v. Sarria* noted that, since the contract in question was made by persons other than Sarria, the plaintiff had to show that the other partners had authority to bind Sarria and that the plaintiff was relying upon the mutual general agency which results from the relation of partnership to show that authority. The court noted that, if the Spanish statute were not applicable, the plaintiff would prevail "for by virtue of the relationship of partnership, one partner becomes the general agent for the other, as to all matters within the scope of the partnership dealings, and has thereby given to him all authority needful for carrying on the partnership, and which is usually exercised by partners in that business" and "that any restriction which by agreement amongst the partners is attempted to be imposed upon the authority, which one partner possesses as the general agent of the other, is operative only between the partners themselves, and does not limit the authority as to third persons . . . unless they know that such restriction has been made." *Sarria*, 69 N.Y. at 28-29. The court noted that the foregoing common law principles, which are comparable to TUPA §§ 9, 13,

[W]here the essentials of a contract made under foreign laws are not hostile to the law and policy of the State, the contract may be relied upon and availed of in the courts of this State. If the substance of the contract is against that law and policy, our judicatories will refuse to entertain it and give it effect.¹⁵⁷³

In *King v. Sarria*, the court held that the Spanish statute limiting liability of particular partners was not contrary to New York public policy and therefore applied the Spanish statute to limit Sarria's liability.¹⁵⁷⁴ However, in reaching this conclusion, the court noted that the Spanish statute resembled New York's own statute for the formation of limited partnerships.¹⁵⁷⁵

The 1982 New York case of *Downey v. Swan*¹⁵⁷⁶ helps answer the question of what happens when the forum state has no corresponding statute. In *Downey*, the defendant Swan was a member of a limited partnership association formed under New Jersey law. Under New Jersey law, the members and managers of a limited partnership association were not personally liable for a wrongful death that occurred on property owned by the partnership. In remanding the case to the trial court for a determination whether the association was operating after its term had expired, the court held that if the association were still in existence, the liabilities of its members would be governed by New Jersey law and the limited liability afforded by that law would be given full effect.¹⁵⁷⁷ Because New York had no limited partnership association law, the New York court could not have applied analogous New York law to reach the same result.¹⁵⁷⁸

In a case involving a Texas LLP law firm, the internal affairs doctrine was recognized by a federal district court in Massachusetts. In *Liberty Mutual Insurance Co. v. Gardere & Wynne, L.L.P.*,¹⁵⁷⁹ although the court granted a motion to transfer a case to a federal court in Texas largely to avoid having to decide numerous questions about the effect of the Texas LLP status¹⁵⁸⁰

14 and 15(1) (without the LLP exception), were qualified by the provisions of any applicable statute providing for the formation of partnerships with limited liability.

1573 *Sarria*, 69 N.Y. at 34.

1574 For a contract to be void as against New York public policy, it must be quite clearly repugnant to the public conscience. See *Kloberg v. Teller*, 171 N.Y.S. 947, 948 (N.Y. Sup. 1918).

1575 The court indicated that the same reasoning would apply to contract and tort claims.

1576 *Downey v. Swan*, 454 N.Y.S. 2d 895 (N.Y. App. Div. 1982).

1577 Cf. *Schneider v. Schimmels*, 64 Cal. Rptr. 273 (Cal. Ct. App. 1967) (California court permitted recovery for loss of consortium pursuant to a Colorado statute although California did not have a similar statute granting such damages).

1578 Cf. *Abu-Nassar v. Elders Futures, Inc.*, 1991 U.S. Dist. LEXIS 3794 (S.D.N.Y. Mar. 28, 1991) (treating an LLC organized under Lebanese law as though it were a foreign corporation for purposes of analyzing choice of law and veil piercing liability).

1579 *Liberty Mutual Insurance Co. v. Gardere & Wynne, L.L.P.*, 1994 WL 707133 (D. Mass. 1994).

1580 *Liberty Mutual Insurance Co. v. Gardere & Wynne, L.L.P.* involved claims of breach of fiduciary duty and conflict of interest asserted by Liberty Mutual Insurance Company ("Liberty") against the Dallas based law firm of Gardere & Wynne, L.L.P. ("Gardere"), which had represented Liberty for many years. Gardere was a Texas partnership that had taken the steps to become a registered LLP under the TRPA. Two Gardere lawyers, Nabors and Woods, also were defendants in the suit; Nabors clearly was a partner in Gardere, but the facts were uncertain about whether Woods's election to "income partner" status had been given effect before he left Gardere to join another firm. Liberty filed its suit in the federal district court in Massachusetts, where its principal office was located. Gardere, Nabors, and Woods moved for dismissal or, alternatively, to have the case transferred to Texas.

on a case pending in Massachusetts which did not have an LLP statute, the limited liability of partners under the Tex. LLP Stats. was recognized under the internal affairs doctrine as follows:

The court assumes that, if this case were tried in a state or federal court in Massachusetts, the court would look to Texas substantive law to determine the liability of partners in a Texas RLLP for debts arising out of claims for breach of fiduciary duty by other partners. *See* Mass.Gen.L. ch. 109, § 48 (liability of limited partners of a foreign limited partnership “shall be governed by the laws of the state under which it is organized”); *Klaxon v. Stentor Elec. Mfg. Co.*, 313 U.S.

Gardere’s motion to dismiss was based upon Massachusetts law providing that a general partnership could not be sued in its common name but that, instead, suit must be brought against each of the partners individually. The individual defendants’ motions to dismiss were based upon a claimed lack of personal jurisdiction over Nabors and Woods by a court located in Massachusetts. Both of these asserted grounds for dismissal would be moot if the case were transferred to Texas, because Texas law permits a partnership to be sued in its common name, and Nabors and Woods clearly were subject to the personal jurisdiction of a court sitting in Texas.

Massachusetts had no counterpart to the Texas LLP statute. The court observed that, if it undertook to consider the motions to dismiss, its analysis would be complicated the fact that Gardere was not a general partnership “in the traditional sense familiar to Massachusetts judges and lawyers.” The court identified numerous procedural and substantive questions emanating from the uncertainty of Gardere’s organizational status under Massachusetts law, including the following issues:

- (1) Whether, for Massachusetts law purpose, Gardere was a limited partnership;
- (2) If Gardere was a limited partnership, whether suit could be brought against it by naming only its general partners as defendants;
- (3) If Gardere was a limited partnership and could be sued by naming only its general partners, whether the “general partners” were only those partners who, under TRPA, could be liable for the alleged breaches of duty claimed by Liberty;
- (4) Whether the breaches of duty alleged by Liberty were the type of “errors, omissions, negligence, incompetence, or malfeasance” enumerated in TRPA for which a registered LLP member’s liability was limited to cases of direct involvement or failure to prevent errors and omissions;
- (5) With respect to the individual defendants’ claims of lack of personal jurisdiction, whether certain Gardere partners who had actually visited Massachusetts from time to time had been agents of other Gardere partners, by operation of general partnership law;
- (6) Whether such presence by other Gardere partners constituted agency on behalf of the individual defendants when it occurred prior to the individual defendants’ joining the Gardere firm; and
- (7) If such agency occurred, whether it was effective with respect to an “income partner” such as Woods, who did not have an equity interest or many of the rights held by equity partners (assuming Woods actually became an income partner).

The court concluded that, despite the deference normally accorded to a plaintiff’s choice of forum, the complicated issues stemming from Gardere’s uncertain legal status under Massachusetts law, combined with the fact these issues would be moot if the case were transferred to Texas, compelled the court to transfer the litigation to a federal district court sitting in Texas. The court thus saved itself from resolving the many issues it had identified that were produced by the incompatibility of Texas and Massachusetts partnership law by transferring the case to Texas.

487, 496, 61 S.Ct. 1020, 1021-22 (1941) (federal court in diversity case applies choice of law principles of state in which federal court is located). Thus, Texas law will apply to this question whether or not the case is transferred . . .¹⁵⁸¹

The *Gardere* case illustrates the difficult procedural issues which can be encountered when liability is asserted against an LLC or an LLP outside of the jurisdiction of its creation. Under general conflict of law principles, (i) for contract claims, in the absence of a valid contractual choice of law provision, the law of the jurisdiction with the most significant contacts will govern; and (ii) for tort claims, the law of the state with the most significant relationship to the occurrence and the parties will generally govern.¹⁵⁸² Whether a court adjudicating a claim against a foreign LLC or LLP, after applying one state's laws in determining that an LLC or LLP is liable for a contract or tort claim, will then apply the internal affairs doctrine or the full faith and credit clause of the Constitution to uphold the liability shield of the entity's jurisdiction of organization remains an issue in those few jurisdictions still lacking statutory guidance, although the better authority to date would apply the internal affairs principle and uphold the statutory liability shield.

7.5. Qualification as Foreign Entity and Other Ways to Reduce Extraterritorial Risk.

Since all 50 states (including Texas) plus the District of Columbia now have LLC statutes, the LLC extraterritorial risk analysis requires analysis of the applicable LLC statute in each of the states in which the LLC contemplates doing business. Generally qualification as a foreign LLC in a jurisdiction will protect Members' limited liability, but failure to qualify may not result in the loss of limited liability, although it may result in the imposition of statutory penalties. The LLC statutes in Texas, New York and Delaware, which each contain provisions for the registration/qualification of foreign LLCs, expressly provide that the failure of a foreign LLC to so qualify shall not affect the limited liability of its members or managers, which shall be determined by the laws of the LLC's jurisdiction of organization.¹⁵⁸³ Likewise, since all states plus the District of Columbia have LLP statutes, foreign qualification needs to be considered as a means of reducing extraterritorial risk for LLPs. Delaware, New York, and Maryland all provide for foreign qualification.¹⁵⁸⁴

¹⁵⁸¹ *Gardere & Wynne*, 1994 WL 707133 at *6 n. 7.

¹⁵⁸² Elizabeth S. Miller, *Procedural and Conflict of Laws Issues Arising In Connection With Multi-State Partnerships*, ABA Bus. L. Sec. (1996 Spring Meeting).

¹⁵⁸³ LLC Act §§ 7.01, 7.02; N.Y. LLC Law §§ 801, 802 (2006); 6 DEL. CODE §§ 18-901, 18-902 (2013). N.Y. LLC Law § 802 further provides that within 120 days after the filing of its application for authority, the foreign LLC must publish once each week for six successive weeks in one daily and one weekly newspaper (each designated by the county clerk in the county where the LLC is located) generally the same information required to be filed with the New York Department of State and must file a proof of publication with the New York Department of State, and failure to file such proof of publication will result in automatic suspension of the LLC's right to transact business in New York.

¹⁵⁸⁴ DEL. CODE ANN. tit. 6 § 15-1101 et seq (2013); N.Y. P'SHIP LAW § 121-1502 (McKinney 1998 & Supp. 2006); MD. CODE ANN., CORPS. & ASS'NS § 9A-1101 (1999). N.Y. P'SHIP LAW § 121-1502 (McKinney 1998 & Supp. 2006) further provides that within 120 days after the filing of its application for authority, the foreign LLP must publish once each week for six successive weeks in one daily and one weekly newspaper (each designated by the county clerk in the county where the LLP is located) generally the same information required to be filed with the New York Department of State and must file a proof of publication with the

Although the LLP is the entity of choice for many professionals, not all states permit all types of professionals to avail themselves of limited liability for professional malpractice (whether through a professional corporation, a PLLC or an LLP), thus necessitating additionally a review of the applicable professional rules in each jurisdiction in which the entity proposes to transact business.¹⁵⁸⁵

New York Department of State, and failure to file such proof of publication will result in automatic suspension of the LLP's right to transact business in New York.

¹⁵⁸⁵ See Rogers, *Questions of Law and Ethics Face Firms Becoming LLPs, LLCs*, 12 ABA/BNA Lawyers' Manual of Professional Conduct 411 (No. 23 Dec. 11, 1996); *Meyer v. Oklahoma Alcoholic Beverage Laws Enforcement Comm'n.*, 890 P.2d 1361 (Okla. Civ. App. 1995) (finding that an LLC is not permitted to hold liquor license).

APPENDIX A

FEDERAL TAXATION OF ENTITIES

A. Federal “Check-The-Box” Tax Regulations.

1. Classification. Under the IRC and the Treasury regulations promulgated thereunder, an unincorporated business entity may be classified as an “association” taxable as a corporation and subject to income taxes at the corporate level ranging from 15% to 35% of taxable net income (absent a valid S-corporation status election) in addition to any taxation which may be imposed on the owner as a result of distributions from the business entity. Alternatively, the entity may be classified as a partnership, a non-taxable “flow-through” entity in which taxation is imposed only at the ownership level. Finally, if it is a single-owner LLC or LP, it may be disregarded as a separate entity for federal income tax purposes.¹

For many years, the IRS classified business entities for purposes of federal income taxation by determining whether an organization had more corporate characteristics than non-corporate characteristics. Thus, if an entity possessed more than two of the corporate characteristics of continuity of life, centralization of management, limited liability, and free transferability of interest, it would be classified as a corporation for purposes of federal income taxation. Effective January 1, 1997, the IRS adopted “the Check-the-Box” Regulations discussed below, which effectively allow a partnership or LLC to elect whether to be taxed as a corporation.

2. Check-the-Box Regulations. On December 18, 1996 the IRS issued Treasury Regulations §§ 301.7701-1, -2 and -3 (the “Check-the-Box Regulations”), which became effective January 1, 1997 and completely replaced the former classification regulations.² Entities now have the assurance of either partnership or corporate classification under a set of default rules or the ability to make an election to obtain the desired classification.³ Although the four factor technical analysis of the IRS’ former classification regulations (“Former Classification Regulations”) has been completely replaced, the IRS still requires certain prerequisites to be fulfilled prior to qualifying under the default rules or making a valid election:⁴

(a) Eligible Entities. Initially, the entity must be a “business entity” that is separate from its owners for federal income tax purposes. A business entity is defined, in part, as any entity recognized for tax purposes that is not classified as a trust under Treas. Reg. § 301.7701-4 or otherwise subject to special treatment under the IRC, e.g., real estate mortgage investment

¹ Rev. Rul. 2004-77, 2004-2 C.B. 119 (July 29, 2004) (“If an eligible entity has two members under local law, but one of the members of the eligible entity is, for federal tax purposes, disregarded as an entity separate from the other member of the eligible entity, then the eligible entity cannot be classified as a partnership and is either disregarded as an entity separate from its owner or an association taxable as a corporation”).

² T.D. 8697, 1997-1 C.B. 215, *corrected by* T.D. 8697, 1997 WL 108762 (IRS TD Mar 13, 1997).

³ Treas. Reg. § 301.7701-3(a) (as amended in 2006).

⁴ *Id.*

conduits (“REMICs”).⁵ The Check-the-Box Regulations do not provide a test for determining when a separate entity exists. Rather, the Check-the-Box Regulations merely state that a separate entity may be created by a joint venture or other contractual arrangement if the participants carry on a trade or business and divide the resulting profits.⁶ Additionally, to be eligible for partnership classification, the business entity must not be automatically classified as a corporation under the Check-the-Box Regulations (e.g., domestic incorporated entities, life insurance companies and most entities whose interests are publicly traded).⁷ Among the entities that the Check-the-Box Regulations automatically classify as corporations are over 85 specific types of foreign business entities.⁸ A business entity that meets the foregoing requirements is an “eligible entity” that need not make an election if the entity meets the requirements of the default rules.⁹

(b) The Default Rules. The default rules under Treas. Reg. § 301.7701-3(b)(1) provide that a domestic eligible entity (an entity organized in the U.S. that is not classified as a corporation) is a partnership if it has two or more members and is disregarded as a separate entity if it has a single owner (i.e., treated as a sole proprietorship or division of the owner). Under Treas. Reg. § 301.7701-3(b)(2), a foreign eligible entity is (i) a partnership if it has two or more members and at least one member has unlimited liability (as determined solely by reference to the law under which the entity is organized),¹⁰ (ii) an association taxable as a corporation if no member has unlimited liability, or (iii) disregarded as a separate entity if it has a single owner with unlimited liability.

(c) The Election Rules. An eligible entity that desires to obtain a classification other than under the default classification rules, or desires to change its classification, may file an election with the IRS on Form 8832 (Entity Classification Election).¹¹ For example, an election will be necessary if a domestic LLC with two or more members qualifies as an eligible entity and the owners desire corporate classification rather than the default partnership classification. The

⁵ Treas. Reg. §§ 301.7701-2(a); *see* I.R.C. §§ 860A, 860D.

⁶ *Id.* § 301.7701-1(a)(2).

⁷ *Id.* § 301.7701-2.

⁸ Treas. Reg. § 301.7701-2(b)(8).

⁹ *Id.* § 301.7701-3(a).

¹⁰ Treas. Reg. § 301.7701-3(b)(2)(ii) provides:

[A] member of a foreign eligible entity has limited liability if the member has no personal liability for the debts of or claims against the entity by reason of being a member. This determination is based solely on the statute or law pursuant to which the entity is organized, except that if the underlying statute or law allows the entity to specify in its organizational documents whether the members will have limited liability, the organizational documents may also be relevant. For purposes of this section, a member has personal liability if the creditors of the entity may seek satisfaction of all or any portion of the debts or claims against the entity from the member as such. A member has personal liability for purposes of this paragraph even if the member makes an agreement under which another person (whether or not a member of the entity) assumes such liability or agrees to indemnify that member for any such liability.

¹¹ *Id.* § 301.7701-3(c).

Treasury Regulations require that each member of an entity, or any officer, manager or member of the entity who is authorized to make the election and who so represents under penalty of perjury, sign Form 8832.¹²

(d) Existing Entities. Under the Check-the-Box Regulations, the classification of eligible entities in existence prior to the effective date of the regulations will be respected by the IRS for all periods prior to January 1, 1997 if (i) the entity had a reasonable basis¹³ for its claimed classification, (ii) the entity and all of the entity's members or partners recognized the federal income tax consequences of any change in the entity's classification within the 60 months prior to January 1, 1997, and (iii) neither the entity nor any member had been notified in writing on or before May 8, 1996 that the entity's classification was under examination by the IRS.¹⁴ Therefore, unless an existing eligible entity elected to change the classification claimed prior to January 1, 1997, the entity will be "grandfathered" and will not be required to make an election to protect its classification. However, the one exception to this rule is when a single owner entity previously claimed to be classified as a partnership.¹⁵ The single owner entity will be disregarded as an entity separate from its owner and thus will be treated as a sole proprietorship, or a branch or division of the owner.¹⁶ If an entity elects to change its classification, there can be severe adverse consequences and tax counsel should be consulted.

3. Former Classification Regulations. Prior to January 1, 1997, under former Treasury Regulation section 301.7701-2¹⁷ (the "Former Classification Regulations"), an unincorporated organization would have been treated by the IRS as an "association" (taxable as a corporation) if the organization had more corporate characteristics than non-corporate characteristics. Thus, if an entity possessed more than two of the four corporate characteristics, it would have been classified as a corporation for purposes of federal income taxation and, if it

¹² *Id.* § 301.7701-3(g)(2).

¹³ The term "reasonable basis" has the same meaning as under I.R.C. § 6662, which addresses the accuracy-related penalties. Treas. Reg. § 301.7701-3(h)(2)(i). The "reasonable basis" standard is defined in Treas. Reg. § 1.6662-3(b)(3) as follows:

Reasonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. If a return position is reasonably based on one or more of the authorities set forth in [Treas. Reg.] § 1.6662-4(d)(3)(iii) (taking into account the relevance and persuasiveness of the authorities, and subsequent developments), the return position will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard as defined in [Treas. Reg.] § 1.6662-4(d)(2).

See American Bar Association Section of Taxation Committee on the Standards of Tax Practice, *Standards of Tax Practice Statement*, 54 TAX LAW. 185, 189 (2000).

¹⁴ Treas. Reg. § 301.7701-3(h)(2).

¹⁵ *Id.* § 301.7701-3(b)(3).

¹⁶ *Id.* §§ 301.7701-3(b)(3)(i), 301.7701-2(a).

¹⁷ Former Treas. Reg. § 301.7701-2 (1967) (codifying *Morrissey v. Comm'r*, 296 U.S. 344, 357–58 (1935)); *see* Boris I. Bittker & James S. Eustice, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 2.02 (5th ed. 1987) (discussing the classification of associations as corporations for federal income tax purposes).

had two or less of the corporate characteristics, it would be classified as a partnership. These four characteristics are still relevant today for the limited purpose of understanding older partnership and LLC agreements in which they may be embodied and they may still be encountered in drafts of new documents based on outdated precedent for years to come, which in each case may unnecessarily (from a tax perspective) restrict the current business objectives of the parties. The following sections discuss the four corporate characteristics:

(a) Continuity of Life. An organization does not have continuity of life if the death, insanity, bankruptcy, retirement, resignation or expulsion of any member would cause dissolution of the organization (hereinafter, “Dissolution Event”).¹⁸ If the occurrence of a Dissolution Event causes a dissolution of the organization, continuity of life does not exist, even if the remaining members have the ability to opt, by unanimous or majority consent, to continue the business.¹⁹ Some states (including Texas) allow the partners of a partnership or members of an LLC to provide in the partnership agreement or company agreement that the business will continue in the event of a Dissolution Event.²⁰ Despite the fact that such an agreement constitutes the agreement of a majority of the members of the organization, the use of any prior agreement to continue the business, by eliminating the possibility of dissolution upon a Dissolution Event, may have created continuity of life and would have jeopardized the classification of the entity as a partnership for federal income tax purposes.²¹ Because continuity

¹⁸ Former Treas. Reg. § 301.7701-2(b). A general or limited partnership formed under a statute corresponding to the Uniform Partnership Act or the Uniform Limited Partnership Act was considered by the IRS to lack continuity of life under Former Treas. Reg. § 301.7701-2(b).

¹⁹ Former Treas. Reg. § 301.7701-2(b). Until 1993, the Former Classification Regulations indicated that such a partnership would avoid continuity of life only if a Dissolution Event resulted in either automatic dissolution or dissolution unless *all* of the remaining partners agreed to continue the business. Thus, it was assumed that a partnership *would* have the corporate characteristic of continuity of life if an agreement of a *majority* of the remaining partners were sufficient to save the partnership from dissolution upon the occurrence of a Dissolution Event. This belief was reinforced by Private Letter Ruling 90-100-27, in which the IRS, considering an LLC’s tax status, ruled that “[b]ecause dissolution under the Act may be avoided by a majority vote of members, rather than unanimous agreement, L possesses the corporate characteristic of continuity of life.” I.R.S. Priv. Ltr. Rul. 90-10-027 (March 9, 1990). The IRS should have based its ruling on the Regulations governing the LLC instead of the statute under which the LLC was formed, regardless of whether a majority vote to continue the business was insufficient to preclude continuity of life. Ultimately, the Former Classification Regulations were amended effective June 14, 1993 to allow “a majority in interest,” rather than “all remaining members,” of a partnership to elect to continue the business after a Dissolution Event. *See* Rev. Rul. 93-91, 1983-2 C.B. 316; Rev. Proc. 95-10, 1995-1 I.R.B. 20 (confirming the applicability of this standard to LLCs).

²⁰ *See, e.g.*, LLC Act §§ 3.02(9), 6.01(B); TBOC § 101.052.

²¹ *See* I.R.S. Priv. Ltr. Rul. 90-30-013 (Apr. 25, 1990) (explaining “no right to continue the business of X upon a [Dissolution Event] is stated in the articles of organization apart from continuance of X’s business upon the consent of all the remaining members. Therefore, if a member of X ceases to be a member of X for any reason, the continuity of X is not assured, because all remaining members must agree to continue the business. Consequently, X lacks the corporate characteristic of continuity of life.”); *see also* I.R.S. Priv. Ltr. Rul. 90-29-019 (Apr. 19, 1990); I.R.S. Priv. Ltr. Rul. 89-37-010 (June 16, 1989); Former Treas. Reg. § 301.7701(b)(1) (explaining “[a]n organization has continuity of life if the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause a dissolution of the organization.”). Arguably, if the members have a preexisting agreement providing that such Dissolution Events will not cause a dissolution, then the organization has continuity of life. It would appear that there must be some uncertainty about the continuation of the business at the time of the Dissolution Event in order to avoid a finding of continuity of life.

of life is no longer relevant to determining whether an entity may be classified as a partnership for federal income tax purposes, attorneys should consider whether Dissolution Events are consistent with the business objectives of the parties and, if they are not, consider means for negating them in partnership and LLC agreements.

(b) Centralization of Management. For this corporate characteristic to be present, the exclusive and continuing power to make necessary management decisions must be concentrated in a managerial group (composed of less than all the members) that has the authority to act on behalf of the organization independently of its members.²² The key to this characteristic is the group's ability to bind the entity in its role as a representative of the organization, as opposed to its role as an owner.

(c) Limited Liability. An organization has the corporate characteristic of limited liability if under local law no member is personally liable for the debts or obligations of the organization when the organization's assets are insufficient to satisfy such debts or obligations.²³ In the case of a limited partnership, the IRS deemed the entity to have limited liability where the general partner has no substantial assets (other than his interest in the partnership) that could be reached by creditors of the entity and the general partner is merely a "dummy" acting as agent of the limited partners.²⁴ To negate such an IRS assertion under the Former Classification Regulations, tax lawyers advised that the general partner should have substantial assets that could be reached by creditors. The capitalization of the general partner is of reduced importance from a tax standpoint under the Check-the-Box Regulations.²⁵

(d) Free Transferability of Interest. The characteristic of free transferability of interest does not exist in a case where a member can, without the consent of other members, assign only his right to a share in the profits but cannot assign his rights to participate in the management of the organization.²⁶ Free transferability does not exist if, under local law, the transfer of a member's interest results in the dissolution of the old entity and the formation of a new entity.²⁷ Partnership and LLC agreements traditionally have contained provisions intended to negate free transferability by giving a general partner or manager the discretion to decide whether to approve a proposed transfer.²⁸ These provisions are no longer appropriate except to

²² Rev. Proc. 95-10, 1995-1 I.R.B. 20; Rev. Rul. 93-6, 1993-1 C.B. 229; *see also* BITTKER & EUSTICE, *supra* note 17, at § 2.02.

²³ Former Treas. Reg. § 301.7701-2(d)(1).

²⁴ Former Treas. Reg. § 301.7701-2(d)(2).

²⁵ In contrast to the Former Classification Regulations and Rev. Proc. 89-12, 1989-7, I.R.B. 22, the Check-the-Box Regulations do not focus on the capitalization of the general partner.

²⁶ Former Treas. Reg. § 301.7701-2(e)(1); *see also* Act of May 9, 1961, 57th Leg., R.S., ch. 158, 1961 Tex. Gen. Laws 289; Act of May 17, 1979, 66th Leg., R.S., ch. 723, § 5, 1979 Tex. Gen. Laws 1782; Act of May 9, 1985, 69th Leg., R.S., ch. 159, § 76, 1985 Tex. Gen. Laws 692; Act of May 9, 1991, 72d Leg., R.S., ch. 901, §§ 83-85, 1991 Tex. Gen. Laws 3234-35; Act of May 31, 1993, 73d Leg., R.S., ch. 917, § 2, 1993 Tex. Gen. Laws 3912-13 (expired Jan. 1, 1999).

²⁷ Former Treas. Reg. § 301.7701-2(d)(2).

²⁸ In contrast to the Former Classification Regulations and Revenue Procedure 89-12, the Check-the-Box Regulations do not focus on the capitalization of the general partner.

the extent necessary to achieve the party's business objectives or to facilitate compliance with securities laws.

B. Business Combinations Generally.

1. Federal Income Tax Consequences. As in the case of organizational choice of entity determinations and business combinations, a conversion transaction should not be undertaken without a thorough analysis of the federal and state income tax consequences of the conversion. The following sections provide a brief summary of some of the federal income tax consequences of certain conversion transactions.²⁹

(a) Conversions of Entities Classified as Partnerships. There generally should be no adverse federal income tax consequences arising from a properly structured conversion of an entity classified as a domestic partnership for federal income tax purposes (e.g., general partnerships, LLPs, limited partnerships and LLCs) into another entity classified as a domestic partnership for federal income tax purposes, provided that the owners' capital and profit interests and shares of entity liabilities do not change as a result of the conversion and the entity's business and assets remain substantially unchanged.³⁰ These transactions are viewed as tax-free contributions under Section 721 of the IRC that do not cause the existing entity to terminate under Section 708, and do not cause the taxable year of the existing entity to close with respect to any or all of the partners or members. A new taxpayer identification number is not required. Careful attention should be paid to determining the partners' or members' correct share of the entity's liabilities before and after the conversion because a decrease in a partner's or member's share of those liabilities that exceeds the partner's or member's adjusted basis in its interest will result in recognition of gain.

The conversion of an entity classified as a partnership to an entity that is ignored for federal income tax purposes will occur if such entity only has a single member. For example, if one member of a two member LLC purchases the other member's interest, the partnership is deemed to make a liquidating distribution of all of its assets to the members, with the purchasing member treated as acquiring the assets distributed to the selling member. However, the selling member is treated as selling a partnership interest.³¹ Liquidations of partners' interests in a partnership generally do not result in recognition of gain by the partners except to the extent that the amount of cash (marketable securities are in certain cases treated as cash) actually or constructively received by a partner exceeds the partner's adjusted basis in his partnership interest.³² Note that distributions of property contributed to the partnership within seven years of the date of the deemed distribution may result in gain recognition pursuant to I.R.C. §§ 704(c)(1)(B) and 737.³³

²⁹ See Monte A. Jackel and Glen E. Dance, *Selected Federal Income Tax Aspects of Changing the Tax Status of Business Entities*, 3 PLI/Tax Strategies 255 (1997).

³⁰ See e.g., Rev. Rul. 95-37, 1995-17 I.R.B.10; Rev. Rul. 86-101, 1986-2 C.B. 94; Rev. Rul. 84-52, 1984-1 C.B. 157.

³¹ Rev. Rul. 99-6, Sit. 1, 1999-1 C.B. 432.

³² See I.R.C. §§ 731, 736, 751(b).

³³ See I.R.C. §§ 704(c)(1)(B), 737.

Conversion of an entity classified as a partnership into a corporation will generally be analyzed as a liquidating transaction with respect to the partnership and an incorporation transaction with respect to the corporation, either of which can result in recognition of gain by the owners of the converted entity.³⁴ Nevertheless, with careful planning, most conversions of this type can be accomplished without recognition of gain.³⁵ The fact pattern most likely to result in taxable income in this context is that in which the partnership's liabilities exceed the partnership's basis in its assets.

(b) Conversions of Entities Classified as Corporations. Conversion of an entity classified as a corporation into an entity classified as a partnership or an entity ignored for federal income tax purposes will generally be treated as a taxable liquidating transaction with respect to the corporation and, in the case of conversion to a partnership entity, a contribution transaction with respect to the partnership entity.³⁶ A corporation cannot be converted into an entity classified as a partnership or sole proprietorship in a tax free transaction. In the case of a C-corporation (other than one that is owned 80% or more by another corporation) the liquidation potentially may be subject to tax at both the corporate and shareholder levels. The corporation will recognize gain or loss equal to the difference between the fair market value of each tangible and intangible asset of the corporation and the corporation's adjusted basis in each respective asset.³⁷ The shareholders will recognize gain or loss equal to the difference between the fair market value of the assets deemed distributed to them and their adjusted basis in the corporation's shares.³⁸ Contrary to "common wisdom" that an S-corporation is taxed like a partnership, the same taxable liquidation rules apply to an S-corporation and its shareholders except that the corporate level gain realized by the S-corporation on the deemed liquidation generally flows through to the individual returns of the shareholders thereby increasing their adjusted bases in their stock and eliminating or decreasing the amount of shareholder level gain.³⁹ In order to comply with the S-corporation single-class-of-stock requirement, careful tax analysis should be undertaken when converting a corporation with an otherwise valid pre-conversion S-corporation election into partnership form electing post-conversion Check-the-Box treatment as a corporation.

C. Taxation of Corporations. Federal taxation of a corporation in the United States depends on whether the corporation is a regular C-corporation, or has instead qualified for and elected S-corporation tax status.

1. Taxation of C-Corporations. C-corporations are separately taxable entities under the IRC. Thus, C-corporation earnings are subject to double taxation--first at the corporate level

³⁴ Treas. Reg. § 301.7701-3(g)(1)(i).

³⁵ See Rev. Rul. 84-111; 1984-2 C.B. 88; see, e.g., Priv. Ltr. Rul. 201214014 (April 6, 2012).

³⁶ Treas. Reg. § 301.7701-3(g)(1)(ii), (iii).

³⁷ I.R.C. § 336.

³⁸ I.R.C. § 331(a).

³⁹ I.R.C. §§ 1371(a), 1367(a)(1)(A); see also I.R.C. § 1363(a); cf. I.R.C. § 1374 (imposing a tax on built-in gains).

and again at the shareholder level upon distribution of dividends. Like the personal income tax, corporate tax rates vary depending on the level of income generated.

The taxable income of a C-corporation is subject to federal income tax at graduated rates ranging from 15% to 35%.⁴⁰ The tax rate schedule for a C-corporation is as follows:⁴¹

If taxable income is:			
Over--	But not over--	Tax is:	Of the amount over--
\$0	\$50,000	15%	-0-
\$50,000	\$75,000	\$7,500 + 25%	\$50,000
\$75,000	\$100,000	\$13,750 + 34%	\$75,000
\$100,000	\$335,000	\$22,250 + 39% ⁴²	\$100,000
\$335,000	\$10,000,000	\$113,900 + 34%	\$335,000
\$10,000,000	\$15,000,000	\$3,400,000 + 35%	\$10,000,000
\$15,000,000	\$18,333,333	\$5,150,000 + 38% ⁴³	\$15,000,000
\$18,333,333	--	35%	-0-

Under the IRC, the capital gains of a corporation are generally taxed at the same rates as ordinary income.⁴⁴

A C-corporation's shareholders must pay individual income taxes on any corporate profits that are distributed to them as dividends. A corporation may reduce its taxable income by paying salaries to its officers, directors or employees, which may help to minimize the effects of double taxation; however, unreasonable compensation may be recharacterized by the IRS as a constructive dividend, which is not deductible by the corporation and is also taxed as income to the officer, director or employee.⁴⁵ There can also be corporate level taxes on excessive accumulations of earnings.

Because a C-corporation is a separately taxable entity, there is no flow-through of income, deductions (including intangible drilling costs and depletion allowances), NOLs or capital losses to a C-corporation's shareholders, although a C-corporation's shareholders are not subject to self-employment tax on distributions they receive. Additionally, a C-corporation can carry forward unused losses and credits, subject to specified limitations. If a C-corporation

⁴⁰ I.R.C. §§ 11(a), 11(b).

⁴¹ I.R.C. § 11(b).

⁴² The tax rate for a C corporation with taxable income in excess of \$100,000 is increased by the lesser of (i) 5% of such excess, or (ii) \$11,750. I.R.C. §§ 11(a), 11(b). This essentially means that an additional 5% of tax is imposed on taxable income between \$100,000 and \$335,000.

⁴³ The tax rate for corporations with taxable income in excess of \$15,000,000 is increased by the lesser of (i) 3% of such excess, or (ii) \$100,000. I.R.C. §§ 11(a), 11(b). This essentially means that an additional 3% of tax is imposed on taxable income between \$15,000,000 and \$18,333,333.

⁴⁴ See I.R.C. § 1201(a).

⁴⁵ See *Pediatric Surgical Associates, P.C. v. Comm'r*, 81 T.C.M. (CCH) 1474 (2001), in which the Tax Court disallowed claimed deductions for salaries paid to shareholder surgeons because it found that the salaries exceeded reasonable allowances for services actually rendered and were disguised nondeductible dividends.

distributes appreciated assets to its shareholders, it will recognize a taxable gain. Furthermore, a C-corporation will generally recognize gain or loss on its liquidation (except for certain liquidations into a parent corporation),⁴⁶ and a shareholder will recognize taxable gain or loss on his or her interest in the corporation upon the corporation's liquidation or the shareholder's disposition thereof. However, both S- and C-corporations may be parties to a tax-free reorganization in which neither the corporation nor its shareholders are subject to taxation.

2. Taxation of S-Corporations.

(a) Effect of S-Corporation Status. S-corporation status is achieved by an eligible C-corporation making an election to be so treated. All shareholders, including their spouses if their stock is community property, must consent to such election. Generally, the result of electing S-corporation status is that no corporate level tax is imposed on the corporation's income. Instead, corporate level income is treated as having been received by the shareholders, whether or not such income was actually distributed, and is taxed at the shareholder level. An S-corporation that was previously a C-corporation is subject to a corporate level tax (i) if it realizes a gain on the disposition of assets that were appreciated (i.e., the fair market value exceeded the tax basis) on the date the S election became effective and the disposition occurs within 10 years of that date (subject to certain temporary exceptions enacted in 2009 and 2010)⁴⁷ (subject to certain very limited exceptions reducing the 10-year recognition period for certain taxpayers in the 2009, 2010, 2011, 2012, 2013 and 2014 tax years),⁴⁸ and (ii) on its excess net passive income (subject to certain limits and adjustments) if it has subchapter C earnings and profits and more than 25% of its gross receipts for the year is passive investment income.⁴⁹

A shareholder's deduction for S-corporation losses is limited to the sum of the amount of the shareholder's adjusted basis in his stock and in the corporation's indebtedness to him.⁵⁰ To the extent a loss is not allowed due to this limitation, the loss generally is carried forward to the next year.⁵¹

(b) Eligibility for S-Corporation Status. To be eligible for S-corporation status, a corporation must (i) be a domestic corporation (i.e., organized under the laws of a state of the

⁴⁶ See I.R.C. § 336; I.R.C. § 337.

⁴⁷ I.R.C. § 1374; Treas. Reg. § 1.1374-1; *but see* temporary exceptions in Sec. 2014 of Small Business Jobs Act of 2010, P.L. 111-240; Sec. 1251 of American Recovery and Reinvestment Act of 2009, P.L. 111-5.

⁴⁸ See I.R.C. § 1374(d)(7)(B) (enacted as part of P.L. 111-5 (American Recovery and Reinvestment Act of 2009) and P.L. 111-240 (Creating Small Business Jobs Act of 2010)) (providing exceptions for (i) in the case of any tax year beginning in 2009 and 2010 if the 7th tax year in the recognition period preceded such year; and (ii) in the case of any tax year beginning in 2011, if the 5th year in the recognition period preceded such tax year). See I.R.C. § 1374(d)(7)(C) (providing that for purposes of determining the net recognized built-in gain for tax years beginning in 2012 or 2013, a five-year recognition period applies in lieu of the otherwise applicable 10-year recognition period. See American Taxpayer Relief Act of 2012, P.L. 112-240, § 326. The five-year recognition period also applied to dispositions during 2014. Tax Increase Prevention Act of 2014, P.L. 113-295, § 138.

⁴⁹ I.R.C. § 1374 (1989).

⁵⁰ I.R.C. § 1366(d)(1); I.R.C. § 1367(b)(2)(A).

⁵¹ I.R.C. § 1366(d)(2)(A).

United States),⁵² (ii) have no more than 100 shareholders (for this purpose, stock owned by a husband and wife is treated as owned by one shareholder and all family members can elect to be treated as one shareholder),⁵³ (iii) have no more than one class of stock⁵⁴ and (iv) have no shareholders other than individuals who are residents or citizens of the U.S. and certain trusts, estates or exempt organizations (e.g., qualified employee benefit plans and I.R.C. § 501(c)(3) organizations).⁵⁵ S-corporations may have a C-corporation as a subsidiary (even if the S-corporation owns 80% or more of the C-corporation). Additionally, an S-corporation may now own a qualified subchapter S subsidiary (“QSSS”). A QSSS includes any domestic corporation that qualifies as an S-corporation and is owned 100% by an S-corporation that elects to treat its subsidiary as a QSSS.⁵⁶ A QSSS is not treated as a corporation separate from the parent S-corporation; and all of the assets, liabilities, and items of income, deduction and credit are treated as though they belong to the parent S-corporation. For purposes of the requirement that an S-corporation have only one class of stock, indebtedness may be treated as a second class of stock unless it meets the requirements of the safe harbor rule for “straight debt”, the definition of which was expanded under the Small Business Job Protection Act of 1996. Certain options may also constitute a prohibited second class of stock. In order for the election of S-corporation status to be effective, the election must be made by all shareholders of the corporation.

(c) Termination of S-Corporation Status. Once an S-corporation election has been made, the election continues in effect until (i) it is voluntarily terminated by holders of more than one-half of the outstanding shares, (ii) the corporation ceases to meet the eligibility requirements specified above, or (iii) the corporation has subchapter C earnings and profits at the close of three consecutive taxable years and has gross receipts for each of such taxable years more than 25% of which are passive investment income.⁵⁷

(d) Liquidation or Transfer of Interest. An S-corporation and its shareholders are treated in a manner similar to the way a C-corporation and its individual shareholders are treated when a shareholder disposes of its interest or the S-corporation is liquidated (except no double tax in most cases) or is a party to a nontaxable reorganization.⁵⁸

3. Contributions of Appreciated Property. Owners of an S- or a C-corporation will generally recognize a taxable gain on appreciated property contributed to the corporation in exchange for shares in the corporation, unless the owners who contribute property will control⁵⁹

⁵² I.R.C. § 1361(b)(1); I.R.C. § 1361(c).

⁵³ I.R.C. § 1361(b)(1)(A)(c)(1) (as amended by The American Jobs Creation Act of 2004).

⁵⁴ I.R.C. § 1361(b)(1)(D).

⁵⁵ I.R.C. §§ 1361(b)(1)(B) and (C) and 1361(c)(6).

⁵⁶ I.R.C. § 1361(b)(3)(B); see Paul G. Klug and Jay Nathanson, *Small Business Job Protection Act of 1996 Increases the Attractiveness of S Corporations*, 53 J. MO. B. 219, 221 (1997).

⁵⁷ I.R.C. § 1362(d)(1)-(3) (2005).

⁵⁸ See BITTKER & EUSTICE, *supra* note 17, at § 6.04.

⁵⁹ For these purposes, I.R.C. § 368(c) defines “control” as follows:

at least 80% of the total combined voting power of all classes of voting stock and at least 80% of the total number of shares of all other classes of stock of the corporation immediately after the transfer.⁶⁰

4. Self-Employment Tax. Shareholders of an S-corporation are generally not subject to self-employment tax on their share of the net earnings of trade or business income of the S-corporation if reasonable compensation is paid to the shareholders active in the business.⁶¹

D. Taxation of General Partnerships.

1. General Rule. A general partnership is basically a conduit for purposes of the liability of its members and the payment of income taxes, and may be classified as a partnership if it has two or more partners.⁶²

2. Joint Venture/Tax Implications. A joint venture is commonly thought of as a limited duration general partnership formed for a specific business activity.⁶³ Unless the venturers elect otherwise, it is treated for federal income tax purposes like a general partnership in that the entity pays no tax; rather, its income or loss is allocated to the joint venturers.⁶⁴

3. Contributions of Appreciated Property. As a general rule, a transfer of appreciated property in exchange for an interest in a general partnership will not result in any gain or loss being recognized by the transferor, the partnership or any of the other partners of the partnership.⁶⁵ The tax basis of the transferor in his partnership interest and of the partnership in the transferred property is the basis the transferor had in the transferred property at the time of the transfer.⁶⁶ Under certain circumstances, a partner's contribution of property may result in a net reduction in liability to that partner in excess of the partner's tax basis in the contributed property. In such a situation, the partner will recognize a gain to the extent of such excess. In addition, certain contributions can be treated as "disguised sales" of all or a portion of the contributed property by the partner to the partnership if the partner receives cash or other property (in addition to a partnership interest) in connection with the transfer.

[O]wnership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

⁶⁰ I.R.C. § 351(a).

⁶¹ Rev. Rul. 59-221, 1959-1 C.B. 225; see also Priv. Ltr. Rul. 87-16-060 (Jan. 21, 1987) (ruling that S-corporation shareholders do not conduct the corporation's business); Burgess J. W. Raby and William L. Raby, *Attempting to Avoid FICA and Self-Employment Tax*, 93 TAX NOTES 803, 803-06 (2001).

⁶² Treas. Reg. § 301.7701-3(b)(1).

⁶³ See, e.g., *Tompkins v. Comm'r*, 97 F.2d 396 (4th Cir. 1938); *United States v. U.S. Nat'l Bank of Portland, Or.*, 239 F.2d 475, 475-80 (9th Cir. 1956).

⁶⁴ I.R.C. § 7701(a)(2) (2012).

⁶⁵ I.R.C. § 721(a). *But see* Treas. Reg. § 1.707-3 (discussing disguised sales).

⁶⁶ I.R.C. § 722; I.R.C. § 723.

4. Self-Employment Tax. Partners of a general partnership generally will be subject to self-employment tax on their share of the net earnings of trade or business income of the partnership and any guaranteed payments for personal services.⁶⁷

E. Taxation of Limited Partnerships.

1. Federal Income Taxation. Unless the partners elect otherwise, a domestic limited partnership should ordinarily be treated as a partnership for federal income tax purposes under the Check-the-Box Regulations so long as it has two or more partners.⁶⁸

2. Contributions of Appreciated Property. With respect to contributions of appreciated property, the same rule applies to limited partnerships as applies to general partnerships: ordinarily, a transfer of appreciated property in exchange for an interest in a limited partnership will not result in any gain or loss being recognized by the transferor, the partnership or any of the other partners of the partnership.⁶⁹ The tax basis of the transferor in his partnership interest, and of the partnership in the transferred property, is the basis the transferor had in the transferred property at the time of the transfer.⁷⁰ Under certain circumstances, a partner's contribution of property may result in a net reduction in liability⁷¹ to that partner in excess of the partner's tax basis in the contributed property. In such a situation, the partner will recognize a gain to the extent of such excess.⁷² In addition, certain contributions can be treated as "disguised sales" of all or a portion of the contributed property by the partner to the partnership if the partner receives cash or other property (in addition to a partnership interest) in connection with the transfer.

3. Self-Employment Tax. A limited partner's share of income of the limited partnership (other than a guaranteed payment for services) is generally not subject to the self-employment tax.⁷³ Guaranteed payments made to a limited partner by the partnership for services rendered and the general partner's share of the net earnings of trade or business income of a limited partnership generally will be subject to self-employment tax.⁷⁴ On January 13, 1997, the IRS issued proposed regulations under IRC § 1402 that would define "limited partner" for employment tax purposes as follows, irrespective of the partner's status under state law, as follows:

Generally, an individual will be treated as a limited partner under the proposed regulations unless the individual (1) has personal liability (as defined in

⁶⁷ I.R.C. § 1402(a) (2004).

⁶⁸ See Treas. Reg. § 301.7701-2(c)(1).

⁶⁹ I.R.C. § 721(a). *But see* Treas. Reg. § 1.707-3 (discussing disguised sales).

⁷⁰ I.R.C. § 722; I.R.C. § 723.

⁷¹ I.R.C. § 752.

⁷² I.R.C. § 731.

⁷³ I.R.C. § 1402(a)(13) (2007); see Robert G. Fishman, *Self-Employment Tax, Family Limited Partnerships and the Partnership Anti-Abuse Regulations*, 74 TAXES 689 (No. 11, Nov. 1996).

⁷⁴ *Lauren A. Howell, et vir. v. Commissioner*, TC Memo 2012-303 (Nov. 1, 2012).

§ 301.7701-3(b)(2)(ii) of the Procedure and Administration Regulations) for the debts of or claims against the partnership by reason of being a partner; (2) has authority to contract on behalf of the partnership under the statute or law pursuant to which the partnership is organized; or, (3) participates in the partnership's trade or business for more than 500 hours during the taxable year. If, however, substantially all of the activities of a partnership involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting, any individual who provides services as part of that trade or business will not be considered a limited partner.⁷⁵

The proposed regulations would also have allowed an individual who fails the test for limited partner status to bifurcate the partnership interest into two classes, one of which could qualify for exclusion from employment taxes if it were demonstrably related to invested capital rather than services.⁷⁶

The Taxpayer Relief Act of 1997 prohibited the IRS from issuing any temporary or final regulations relating to the definition of a limited partner for employment tax purposes that would be effective before July 1, 1998.⁷⁷ The legislative history indicates that Congress wanted the IRS to withdraw the controversial proposed regulation discussed above, which would impose a tax on limited partners.⁷⁸ A “sense of the Senate” resolution in the Senate amendment expressed dissatisfaction with the proposed regulation, noting that Congress, not the Treasury or the IRS, should determine the law governing self-employment income for limited partners.⁷⁹

The IRS is nevertheless successfully challenging taxpayer claims of limited partner status where the taxpayer provided services to the partnership.⁸⁰

F. Taxation of LLCs.

1. Check the Box Regulations. Domestic LLCs that have two or more Members ordinarily will be classified as partnerships for federal income tax purposes unless the LLC makes an election to be classified as an association taxable as a corporation.⁸¹ A single Member

⁷⁵ Definition of Limited Partner for Self-Employment Tax Purposes, Prop. Treas. Reg. 1.1402(a)-2(h), 62 Fed. Reg. 1702-01 (Jan. 13, 1997).

⁷⁶ *Id.*

⁷⁷ Taxpayer Relief Act of 1997, Pub. L. 105-34, 111 Stat. 788 (1997) (enacted).

⁷⁸ Taxpayer Relief Act of 1997, H.R. 2014, 105th Cong. § 734 (1997) (enacted).

⁷⁹ S. 949, 105th Cong. § 734 (1997).

⁸⁰ *See Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 TC 137 (Feb. 9, 2011) (partners' distributive shares of the law firm's income found not to arise as a return on the partners' investment and were not “earnings which are basically of an investment nature;” the attorney partners' distributive shares arose from legal services they performed on behalf of the law firm and were held to be self-employment income); *Lauren A. Howell v. Commissioner*, TC Memo 2012-303 (Nov. 1, 2012) (spouse providing marketing advice, signing contracts, contributing a business plan and providing credit card held “not merely a passive investor” and not a limited partner for self-employment tax purposes).

⁸¹ Treas. Reg. § 301.7701-3(b)(i) (as amended in 2003).

LLC will be disregarded as an entity separate from its owner under the Check-the-Box Regulations unless the LLC elects to be taxed as a corporation.⁸²

2. Other Tax Issues Relating to LLCs.

(a) Flexible Statute. In Revenue Ruling 88-76,⁸³ a Wyoming LLC was held to lack continuity of life and free transferability of interest, because the Wyoming LLC *statute* requires the unanimous vote of *all* remaining Members to continue the LLC upon a Dissolution Event, and the consent of *all* LLC Members for any transferee of an interest to participate in the management of the LLC or to become a Member.⁸⁴ The Wyoming LLC statute was considered a “bullet proof statute” because an LLC formed thereunder would always lack these two corporate characteristics important under the Former Classification Regulations.⁸⁵ By contrast, the Tex. LLC Stats. are considered “flexible” statutes because they allow the Members to vary the Regulations or Company Agreement to allow greater organizational flexibility (thus, creating the possibility that an LLC organized thereunder would be taxable as an “association” rather than a partnership under the Former Classification Regulations).⁸⁶

(b) One Member LLC. The Tex. LLC Stats. permit formation of a one-Member LLC, the status of which is now certain under the Check-the-Box Regulations.⁸⁷ As previously stated, for federal income tax purposes, a single Member domestic LLC will be disregarded as an entity separate from its owner unless it elects to be taxed as a corporation.⁸⁸ Some state LLC statutes do not authorize single Member LLCs.⁸⁹

⁸² Treas. Reg. § 301.7701-3(b)(ii).

⁸³ 1988-2 C.B. 360, *obsoleted* by Rev. Rul. 98-37, 1998-2 C.B. 133.

⁸⁴ Rev. Rul. 88-76, 1988-2 C.B. 360, *obsoleted* by Rev. Rul. 98-37, 1998-2 C.B. 133.

⁸⁵ Rev. Rul. 88-76, WYO. STAT. ANN. §§ 17-15-101–17-15-147 (Michie 2003).

⁸⁶ LLC Act §§ 3.02(A), 6.01(B); TBOC § 101.052.

⁸⁷ Treas. Reg. § 301.7701-2(a), (c)(2) (as amended in 2003).

⁸⁸ In I.R.S. Priv. Ltr. Rul. 2001-18023 (Jan. 31, 2001), the issue was the application of § 1031 of the IRC (dealing with tax-free like-kind property exchanges) to a transaction in which an individual conveyed qualifying real property to the sole member of an LLC for the membership interest of a single member LLC (which is a disregarded business entity for federal tax purposes). The conveyance of the real property to the taxpayer would be subject to a real estate transfer fee under state law, but the transfer of an ownership interest in an LLC to the taxpayer would not be subject to the transfer fee. To avoid incurring a liability for the local real estate transfer fees incident to the transfer of the real property by the LLC, the taxpayer was proposing to simply acquire the LLC from its single member. The IRS ruled that, because the LLC is a single member LLC and will, therefore, be disregarded as an entity separate from its owner, the receipt of the ownership of the LLC by the taxpayer is treated as the receipt by the taxpayer of the real property owned by the LLC. Accordingly, the taxpayer’s receipt of the sole membership interest in the LLC which owns the real property would be treated as the receipt of real property directly by the taxpayer for purposes of qualifying the receipt of the real property for non-recognition of gain under § 1031. The ruling applies only to the extent the property held by the LLC at the time it is transferred to the taxpayer is property of a like kind to the real property held for use by the taxpayer in his trade or business or for investment (not like kind property held by the LLC would be taxable to the taxpayer as boot).

⁸⁹ See Larry E. Ribstein, *The Emergence of the Limited Liability Company*, 51 BUS. LAW. 1, 7 (1995).

(c) Contributions of Appreciated Property. As a general rule, a transfer of appreciated property in exchange for an interest in an LLC classified as a partnership will not result in any recognizable gain or loss for the transferor, the LLC or any other Member of the LLC.⁹⁰ The tax basis of the transferor in the LLC interest thereof and of the LLC in the transferred property is the basis the transferor had in the transferred property at the time of the transfer.⁹¹ Under certain circumstances, a Member's contribution of property may result in a net reduction in liability⁹² to that Member in excess of the Member's tax basis in the contributed property. In such a situation, the Member will recognize a gain to the extent of such excess.⁹³ In addition, certain contributions can be treated as "disguised sales" of all or a portion of the contributed property by the member to the LLC if the member receives cash or other property (in addition to an LLC interest) in connection with the transfer.

3. Self-Employment Tax. Individuals are subject to a self-employment tax on self-employment income.⁹⁴ The tax rate on self-employment income aggregates up to 15.3% and consists of (i) a 12.40% social security equivalent tax on self-employment income up to a 2015 contribution base of \$118,500 (adjusted annually for inflation), plus (ii) a 2.9% (3.8% on individual self-employment income in excess of \$200,000 [\$250,000 in the case of a joint return; \$125,000 in the case of a married taxpayer filing separately]) component for hospital insurance ("Medicare") (there is no ceiling).⁹⁵ An individual's wage income is applied against the contribution base.⁹⁶ Self-employment income generally means an individual's net earnings from the individual's trade or business.⁹⁷ An individual's self-employment income includes his distributive share of the trade or business income from a partnership of which he is a partner (including an LLC classified as a partnership for federal income tax purposes), *subject to* the exception that a limited partner's distributive share of income or loss from a limited partnership generally will not be included in his net income from self employment.⁹⁸

In 1994, the IRS issued proposed regulations providing that an individual Member's share of income from a trade or business of the LLC is subject to self-employment tax (assuming

⁹⁰ I.R.C. § 721(a). *But see* Treas. Reg. § 1.707-3 (2003) (discussing disguised sales).

⁹¹ I.R.C. §§ 722, 723.

⁹² I.R.C. § 752.

⁹³ I.R.C. § 731.

⁹⁴ *See* I.R.C. § 1401; SSA Pub. No. 05-10003 (2014), available at <http://www.ssa.gov/pubs/10003.html>.

⁹⁵ The combined rate of tax on self-employment income of 15.3% consists of a 12.4% component for old-age, survivors, and disability insurance ("OASDI" or "social security") and a 2.9% (3.8% on individual self-employment income in excess of \$200,000 [\$250,000 in the case of a joint return; \$125,000 in the case of a married taxpayer filing separately]) component for hospital insurance ("Medicare"). A similar addition to Medicare tax applies for FICA purposes. This self-employment tax is treated as part of the income tax and must also be taken into account for purposes of the estimated tax. If the taxpayer has wages subject to FICA, then the taxpayer's social security equivalent wage base would be reduced by amount of wages on which these taxes were paid. There is no cap on self-employment income subject to the Medicare tax.

⁹⁶ I.R.C. § 1401(b)(2)(B).

⁹⁷ I.R.C. § 1402(a).

⁹⁸ I.R.C. § 1402(a). *See Howell v. Comm'r*, TC Memo 2012-303 (Nov. 1, 2012).

the LLC is treated as a partnership for federal income tax purposes) unless (i) the Member is not a managing Member and (ii) the entity could have been formed as a limited partnership rather than an LLC in the same jurisdiction with the Member qualifying as a limited partner.⁹⁹ Under such regulations, if the LLC did not have designated Managers with continuing and exclusive authority to manage the LLC, then all Members would be treated as Managers for this purpose.

On January 13, 1997 the IRS withdrew its 1994 proposed regulation dealing with employment taxes in the LLC context and proposed new regulations that would apply to all entities (including LLCs) classified as partnerships under the Check-the-Box Regulations.¹⁰⁰ The IRS said that it was proposing a “functional” approach that would define “limited partner” for federal tax purposes, irrespective of the state law classification, because of the proliferation of new business entities such as the LLC as well as the evolution of state limited partnership statutes.¹⁰¹ Under the proposed regulations:

Generally, an individual will be treated as a limited partner under the proposed regulations unless the individual (1) has personal liability (as defined in section 301.7701-3(b)(2)(ii) of the Procedure and Administration Regulations) for the debts of or claims against the partnership by reason of being a partner; (2) has authority to contract on behalf of the partnership under the statute or law pursuant to which the partnership is organized; or, (3) participates in the partnership’s trade or business for more than 500 hours during the taxable year. If, however, substantially all of the activities of a partnership involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting, any individual who provides services as part of that trade or business will not be considered a limited partner.¹⁰²

Until the proposed regulations are effective for an LLC Member, there is a risk that the IRS will treat any individual Member’s distributive share of the trade or business income of the LLC as being subject to self-employment tax, even if the Member is not a Manager and would be treated as a limited partner under the 1997 proposed regulations, based on the IRS position set forth in Private Letter Ruling 94-32-018, which was issued prior to the proposed regulation. Under both current law and the 1997 proposed regulations, an LLC Member will be subject to self-employment tax on guaranteed payments for services, and Members will not be subject to self-employment tax on distributions if the LLC is treated as an association taxable as a corporation for Federal tax purposes.

The Taxpayer Relief Act of 1997 prohibited the IRS from issuing any temporary or final regulations relating to the definition of a limited partner for employment tax purposes that would be effective before July 1, 1998.¹⁰³ The legislative history indicates that Congress wanted the IRS to withdraw the controversial proposed regulation discussed above, which would impose a

⁹⁹ See 26 C.F.R. § 1.1402(a)-18, 59 Fed. Reg. 67,253-01 (proposed Dec. 29, 1994).

¹⁰⁰ 26 C.F.R. § 1.1402(a)-2, 62 Fed. Reg. 1702 (proposed Jan. 13, 1997).

¹⁰¹ *See id.*

¹⁰² *Id.*

¹⁰³ H.R. CONF. REP. NO. 105-220, at 765 (1997).

tax on limited partners.¹⁰⁴ A “sense of the Senate” resolution in the Senate amendment expressed dissatisfaction with the proposed regulation, noting that Congress, not the Treasury or the IRS, should determine the law governing self-employment income for limited partners.¹⁰⁵ Congress may again consider ways to rationalize the self-employment tax treatment of LLCs, partnerships and S-corporations.¹⁰⁶

The IRS is nevertheless successfully challenging taxpayer claims of limited partner status where the taxpayer provided services to the partnership.¹⁰⁷

G. Taxation of LLPs.

1. Federal Tax Classification. Since a domestic LLP must have two or more partners, it can be classified as a partnership for federal income tax purposes under the Check-the-Box Regulations.¹⁰⁸

2. Self-Employment Tax. Partners in an LLP generally will be subject to self-employment tax on their share of the trade or business income of the LLP since an LLP is a species of general partnership and under state law different from a limited partnership.¹⁰⁹

¹⁰⁴ *Id.*

¹⁰⁵ *Id.* In a letter to the Chairman of the House Ways and Means Committee dated July 6, 1999, the American Bar Association Tax Section commented on the uncertainty of the law in this area, recommending that the IRC be amended to provide that the income of an entity taxable as a partnership (including an LLC) that is attributable to capital is not subject to self-employment tax, but suggested that, if legislation is not forthcoming, the best immediately available approach is that contained in the 1997 proposed regulations. Paul A. Sax, *ABA Tax Section Suggests Legislative Fix for LLC Self-Help Employment Tax*, TAX NOTES TODAY, July 13, 1999, 1999 TNT 133-23, available at <http://www.taxanalysts.com>.

¹⁰⁶ See “*Options to Improve Tax Compliance and Reform Tax Expenditures*” prepared by the Staff of the Joint Committee on Taxation (January 27, 2005).

¹⁰⁷ See *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 TC 137 (Feb. 9, 2011) (partners’ distributive shares of the law firm’s income found not to arise as a return on the partners’ investment and were not “earnings which are basically of an investment nature;” the attorney partners’ distributive shares arose from legal services they performed on behalf of the law firm and were held to be self-employment income); *Lauren A. Howell v. Commissioner*, TC Memo 2012-303 (Nov. 1, 2012) (spouse providing marketing advice, signing contracts, contributing a business plan and providing credit card held “not merely a passive investor” and not a limited partner for self-employment tax purposes); Chief Counsel Advice 201436049 (members of investment management firm organized as LLC subject to self-employment tax where members worked for LLC full time and their services resulted in the LLC’s management fee income).

¹⁰⁸ Treas. Reg. § 301.7701-3(b)(1).

¹⁰⁹ *Renkemeyer, Campbell & Weaver, LLP v. Comm’r*, 136 TC 137 (Feb. 9, 2011) (partners’ distributive shares of the law firm’s income found not to arise as a return on the partners’ investment and were not “earnings which are basically of an investment nature;” the attorney partners’ distributive shares arose from legal services they performed on behalf of the law firm and were held to be self-employment income); see Burgess J. W. Raby & William L. Raby, *Partners, LLC Members, and SE Tax*, 87 TAX NOTES 665, 668 (April 26, 2000).

APPENDIX B

TEXAS MARGIN TAX

1. Corporations and LLCs, but not Partnerships, Subject to Former Franchise Tax. Through December 31, 2006, corporations and LLCs were subject to the former version of the Texas franchise tax,¹ which was equal to the greater of (i) 0.25% of “taxable capital” (generally owners’ equity) and (ii) 4.5% of “net taxable earned surplus.” “Net taxable earned surplus” was computed by determining the entity’s reportable federal taxable income and adding to that amount the compensation of officers and directors. The add-back was not required if (x) the corporation had not more than 35 shareholders or was an S-corporation for federal tax purposes with no more than 75 shareholders,² or (y) the LLC had not more than 35 members.³ The result was apportioned to Texas based on the percentage of its gross receipts from Texas sources. Although labeled a “franchise tax,” the tax on “net taxable earned surplus” was really in most cases a 4.5% income tax levied at the entity level.

Limited and general partnerships (including the LLP) were not subject to the former franchise tax in deference to article 8, Section 24(a) of The Texas Constitution.⁴ The Texas Comptroller of Public Accounts (“Comptroller”) had issued private letter rulings stating that it would honor the state law classification of an entity as a partnership, despite any Check-the-Box election by the partnership to be treated as a corporation for federal income tax purposes.⁵

2. Franchise Tax Change Proposals. Efforts to reduce Texas’ dependence on property taxes to fund public schools led the 1997 through 2005 Texas Legislatures to consider, but not adopt, proposed changes in the Texas tax system which would subject partnerships to the franchise tax.⁶ The 2005 Texas Legislature also proposed: (i) a payroll based tax; and (ii) an

¹ TEX. TAX CODE § 171.001 (Vernon 2002 & Supp. 2004).

² TEX. TAX CODE § 171.110(b) (Vernon 2002 & Supp. 2004).

³ 34 TEX. ADMIN. CODE § 3.558(b)(10) (2002) (Public Finance, Franchise Tax, Earned Surplus: Officer and Director Compensation).

⁴ Commonly referred to as the “Bullock Amendment” and prohibiting income based taxes on a person’s share of partnership income.

⁵ See, e.g., Comptroller Taxpayer Response Letter Accession No. 9811328L (Nov. 30, 1998).

⁶ See Tex. H.B. 3146, 78th Leg., R.S. (2003), available at <http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=78R&Bill=HB3146> (“2003 H.B. 3146”). 2003 H.B. 3146 in the 2003 Legislative Session, by Representative Ron Wilson, attempted to amend the Texas Tax Code to define “corporation” for franchise purposes as “every corporation, limited liability company, limited partnership, business trust, real estate investment trust, savings and loan association, banking corporation, and any other entity for which any of the owners have limited liability” and exclude, in the case of a partnership, the distributive share of the partnership’s income or loss attributable to natural persons. See also Tex. H.B. 3, 79th Leg. R.S. (2005), available at <http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=79R&Bill=HB3>. House Bill 3, as passed by the House on March 14, 2005, would have enacted a Reformed Franchise Tax which would have applied to most business entities, including most corporations, LLCs and partnerships, and allow them to elect either (i) 1.15% tax on Texas employee wages with no ceiling or (ii) the existing franchise tax at the rate of 4.5% of net taxable earned surplus. In the event an unincorporated entity owned wholly or partially

extension of the Texas franchise tax to foreign corporations earning Texas source income from Texas based partnerships. In 2006, property tax reform efforts were primarily motivated by the Texas Supreme Court's decision in *Neeley v. West Orange-Cove Consolidated Independent School District*.⁷ The Court in *West Orange-Cove* held that the property tax rate cap then in effect of \$1.50 per \$1,000 of valuation violated Article VIII, Section 1-e of the Texas Constitution, which prohibits the imposition of a statewide property tax. The Court directed the Texas Legislature to cure the defect by June 1, 2006. In anticipation of a Supreme Court decision in *West Orange-Cove*, on November 4, 2005, Governor Rick Perry appointed a 24-member Texas Tax Reform Commission and former Comptroller John Sharp as its Chairman (the "Sharp Commission") to study and make recommendations on how to reform Texas' business tax structure and provide significant property tax relief and also to later address court-mandated changes in how Texas funds its schools. On November 21, 2005 (the day before the Supreme Court decision in *West Orange-Cove*), the Sharp Commission held the first of a series of public hearings at which various affected parties testified as to what should be changed. On March 29, 2006, the Sharp Commission released its report (the "Sharp Commission Report") which recommended that (1) the Legislature should cut school district property taxes for maintenance and operations substantially (with many districts setting rates at or near \$1.50 per \$100 of valuation, the Sharp Commission recommended that the property tax rate should be lowered to \$1 per \$100 and permanently re-capped at no more than \$1.30 per \$100 by the 2007 tax year and reductions for the 2006 tax year sufficient to comply with the Supreme Court's mandate to be provided immediately) and (2) the Legislature should reform the state's franchise tax by (a) broadening the base of businesses that pay into the system to include most entities whose owners are generally protected from the entities' liabilities, (b) cutting the franchise tax rate from 4.5% to 1%, (c) basing the franchise tax on a business' margin by allowing each business to choose between deducting either the cost of goods sold or employee or partner compensation (including health insurance, pensions and other benefits) from its total revenue, and (d) increasing the small-business exemption from \$150,000 to \$300,000 in total revenue and exempting sole proprietors and "non-corporate general partnerships."⁸ The Sharp Commission Report also recommended raising the tax on cigarettes by \$1 per pack.

by natural persons elects to be subject to the franchise tax, H.B. 3 required that the business and those natural persons agree pursuant to an election form that the taxable earned surplus of the business shall be calculated without regard to any exclusion, exemption or prohibition set forth in Article 8, Section 24(a), of the Texas Constitution (the "*Bullock Amendment*"), which effectively recognizes the applicability of the Bullock Amendment to any form of income tax imposed on an unincorporated entity in which an interest is owned by a natural person. On May 11, 2005, the Senate passed C.S. H.B. 3, which, like H.B. 3, would have included most corporations, LLCs and partnerships as "taxable entities" and would have allowed the entities to elect to be subject to either (1) a 1.75% tax on Texas employee wages up to a cap of \$1,500 per employee or (2) a 2.5% business activity tax which is similar to the current franchise tax plus all compensation exceeding \$30,000 per employee; in each case subject to a minimum tax of 0.25% of Texas gross receipts. Both the House and Senate bills included additional sales and other consumption taxes, although there were significant differences in the two bills. This tax legislation died in a Conference Committee at the end of the 2005 Legislative Session.

⁷ 176 S.W.3d 746 (Tex. 2005).

⁸ A draft of the legislation proposed by the Sharp Commission can be found at http://www.governor.state.tx.us/priorities/tax_reform/TTRC_report/files/tax_reform_bill.pdf.

3. Margin Tax. In a Special Session which convened on April 17, 2006 and adjourned *sine die* on May 15, 2006, the Texas Legislature passed House Bill 3 (“2006 H.B. 3”).⁹ Texas Tax Code Chapter 171¹⁰ was amended by 2006 H.B. 3 to replace the current franchise tax on corporations and LLCs with a new and novel business entity tax called the “Margin Tax” herein. In the 2007 Legislative Session the Margin Tax provisions of the Texas Tax Code were amended by 2007 H.B. 3928.

In the 2009 Texas Legislative Session, only three bills that passed amended Chapter 171 of the Texas Tax Code. One of the bills clarified the method that banks may use to apportion income related to loans and securities to be consistent with prior Texas Comptroller policy.¹¹ This change clarified that FASB 115 “trading securities” must be treated as inventory items and that the aggregate proceeds from trading shall be included in a lending institution’s apportionment formula. The second bill raised the small business threshold for Margin Tax payers from \$300,000 of gross revenue up to \$1,000,000 of gross revenue for the 2010 and 2011 tax years.¹² The third bill,¹³ 2009 S.B. 636, allowed “destination management companies” to exclude “payments made to other persons to provide services, labor, or materials in connection with the provision of destination management services” from gross receipts in calculating their Texas Margin Tax liability. The travel agent industry was one of the industries hardest hit by the lack of a deduction for pass-through expenses under the Margin Tax, and 2009 S.B. 636 provided some relief by excluding certain pass-through payments from gross receipts.

⁹ Tex. H.B. 3, 79th Leg., 3d C.S. (2006) (“2006 H.B. 3”); the text of 2006 H.B. 3 can be viewed in its entirety at the following link: <http://www.legis.state.tx.us/BillLookup/Text.aspx?LegSess=793&Bill=HB3>. See Ira A. Lipstet, *Franchise Tax Reformed: The New Margin Tax Including 2007 Legislative Changes and Final Comptroller Rules*, 42 TEX. J. BUS. L. 1 (2007).

¹⁰ Chapter 171 of the Texas Tax Code was modified and largely replaced by the provisions of 2006 H.B. 3. References in the following footnotes to the “Texas Tax Code” are references to Chapter 171 of the Texas Tax Code as amended in 2006 by 2006 H.B. 3 and in 2007 by H.B. 3928. 2007 H.B. 3928 by Rep. Jim Keffer, 80th Leg., R.S. (2007) (“2007 H.B. 3928”), available at <http://www.legis.state.tx.us/BillLookup/History.aspx?LegSess=80R&Bill=HB3928>.

¹¹ H.B. 4611 by Rep. Rene Oliveira (D-Brownsville), available at <http://www.legis.state.tx.us/BillLookup/Text.aspx?LegSess=81R&Bill=HB4611> (“2009 H.B. 4611”). 2009 H.B. 4611 clarified that “lending institutions” (defined in § 171.0001(10) of the Texas Tax Code) shall include gross proceeds (rather than net proceeds) from the sale of trading securities (as defined in FASB 115) in gross receipts for apportionment purposes. A similar interpretation had been applied under § 171.105(a) of the former Texas franchise tax.

¹² H.B. 4765 by Rep. Rene Oliveira (D-Brownsville), available at <http://www.legis.state.tx.us/BillLookup/Text.aspx?LegSess=81R&Bill=HB4765> (“2009 H.B. 4765”) (increased the small business exemption from the franchise tax from \$300,000 to \$1 million for 2010 and 2011 tax years, contingent on the passage of an increase in the smokeless tobacco tax; the increased exemption would have expired on December 31, 2011; thereafter, the exemption would be reduced from \$1 million to \$600,000 absent future amendments; the reduction was made contingent on the passage of an increase in the smokeless tobacco tax; 2009 H.B. 4765 is effective January 1, 2010); H.B. 2154 Rep. Al Edwards (D-Houston), available at <http://www.legis.state.tx.us/BillLookup/Text.aspx?LegSess=81R&Bill=HB2154> (“2009 H.B. 2154”) (provided the smokeless tobacco tax required by 2009 H.B. 4765).

¹³ S.B. 636 by Sen. Kel Seliger (R-Amarillo), available at <http://www.legis.state.tx.us/BillLookup/Text.aspx?LegSess=81R&Bill=SB636> (“2009 S.B. 636”). The bill adds a new subsection 171.1011(g-6) to the Texas Tax Code.

(a) Who is Subject to Margin Tax. The Margin Tax is imposed on all businesses except: (i) sole proprietorships, (ii) general partnerships “the direct ownership of which is entirely composed of natural persons,” and (iii) certain “passive” entities.¹⁴ Thus, corporations,

¹⁴ Texas Tax Code § 171.0002 defines “taxable entity” as follows:

Sec. 171.0002. DEFINITION OF TAXABLE ENTITY. (a) Except as otherwise provided by this section, "taxable entity" means a partnership, limited liability partnership, corporation, banking corporation, savings and loan association, limited liability company, business trust, professional association, business association, joint venture, joint stock company, holding company, or other legal entity. The term includes a combined group. A joint venture does not include joint operating or co-ownership arrangements meeting the requirements of Treasury Regulation Section 1.761-2(a)(3) that elect out of federal partnership treatment as provided by Section 761(a), Internal Revenue Code.

(b) "Taxable entity" does not include:

- (1) a sole proprietorship;
- (2) a general partnership:
 - (A) the direct ownership of which is entirely composed of natural persons; and
 - (B) the liability of which is not limited under a statute of this state or another state, including by registration as a limited liability partnership;
- (3) a passive entity as defined by Section 171.0003; or
- (4) an entity that is exempt from taxation under Subchapter B.

(c) "Taxable entity" does not include an entity that is:

- (1) a grantor trust as defined by Sections 671 and 7701(a)(30)(E), Internal Revenue Code, all of the grantors and beneficiaries of which are natural persons or charitable entities as described in Section 501(c)(3), Internal Revenue Code, excluding a trust taxable as a business entity pursuant to Treasury Regulation Section 301.7701-4(b);
- (2) an estate of a natural person as defined by Section 7701(a)(30)(D), Internal Revenue Code, excluding an estate taxable as a business entity pursuant to Treasury Regulation Section 301.7701-4(b);
- (3) an escrow;
- (4) a real estate investment trust (REIT) as defined by Section 856, Internal Revenue Code, and its "qualified REIT subsidiary" entities as defined by Section 856(i)(2), Internal Revenue Code, provided that:
 - (A) a REIT with any amount of its assets in direct holdings of real estate, other than real estate it occupies for business purposes, as opposed to holding interests in limited partnerships or other entities that directly hold the real estate, is a taxable entity; and
 - (B) a limited partnership or other entity that directly holds the real estate as described in Paragraph (A) is not exempt under this subdivision, without regard to whether a REIT holds an interest in it;
- (5) a real estate mortgage investment conduit (REMIC), as defined by Section 860D, Internal Revenue Code;
- (6) a nonprofit self-insurance trust created under Chapter 2212, Insurance Code, or a predecessor statute;
- (7) a trust qualified under Section 401(a), Internal Revenue Code; or
- (8) a trust or other entity that is exempt under Section 501(c)(9), Internal Revenue Code.

limited partnerships, certain general partnerships, LLPs, LLCs, business trusts and professional associations are subject to the Margin Tax.¹⁵ The Margin Tax is not imposed on sole proprietorships, general partnerships that are owned 100% by natural persons or the estate of a natural person,¹⁶ certain narrowly defined passive income entities¹⁷ (including certain real estate

(d) An entity that can file as a sole proprietorship for federal tax purposes is not a sole proprietorship for purposes of Subsection (b)(1) and is not exempt under that subsection if the entity is formed in a manner under the statutes of this state, another state, or a foreign country that limit the liability of the entity.

¹⁵ Texas Tax Code Ann. § 171.0002(a).

¹⁶ Since an LLP is classified under both the TRPA and the TBOC as a species of general partnership, under a literal reading of 2006 H.B. 3 the Margin Tax would not have been applicable to an LLP composed solely of natural persons. Various statements by the Sharp Commission and the offices of the Governor and the Comptroller suggested that the Margin Tax was generally intended to apply to any entity that afforded limited liability to its owners, which would include the LLP. 2007 H.B. 3928 resolved this issue by amending Texas Tax Code § 171.0002 to expressly provide that an LLP is subject to the Margin Tax.

¹⁷ Texas Tax Code Ann. § 171.0003 defines “passive entity” as follows:

Sec. 171.0003. DEFINITION OF PASSIVE ENTITY. (a) An entity is a passive entity only if:

- (1) the entity is a general or limited partnership or a trust, other than a business trust;
- (2) during the period on which margin is based, the entity’s federal gross income consists of at least 90 percent of the following income:
 - (A) dividends, interest, foreign currency exchange gain, periodic and nonperiodic payments with respect to notional principal contracts, option premiums, cash settlement or termination payments with respect to a financial instrument, and income from a limited liability company;
 - (B) distributive shares of partnership income to the extent that those distributive shares of income are greater than zero;
 - (C) capital gains from the sale of real property, gains from the sale of commodities traded on a commodities exchange, and gains from the sale of securities; and
 - (D) royalties, bonuses, or delay rental income from mineral properties and income from other nonoperating mineral interests; and
- (3) the entity does not receive more than 10 percent of its federal gross income from conducting an active trade or business.

(a-1) In making the computation under Subsection (a)(3), income described by Subsection (a)(2) may not be treated as income from conducting an active trade or business.

(b) The income described by Subsection (a)(2) does not include:

- (1) rent; or
- (2) income received by a nonoperator from mineral properties under a joint operating agreement if the nonoperator is a member of an affiliated group and another member of that group is the operator under the same joint operating agreement.

As used in the definition of “passive entity,” Texas Tax Code § 171.0004 defines “conducting active trade or business” as follows:

Sec. 171.0004. DEFINITION OF CONDUCTING ACTIVE TRADE OR BUSINESS. (a) The definition in this section applies only to Section 171.0003.

(b) An entity conducts an active trade or business if:

investment trusts (“REITs”),¹⁸ grantor trusts,¹⁹ estates of a natural person, an escrow,²⁰ or a REMIC. Effective January 1, 2012, the Margin Tax does not apply to certain unincorporated political action committees.²¹ Political action committees formed as Texas non-profit corporations are still subject to the Texas franchise tax.²²

(b) Passive Entities. In order to be exempt in any given tax year, a “passive entity” must receive at least 90% of its gross income, for federal income tax purposes,²³ from

(1) the activities being carried on by the entity include one or more active operations that form a part of the process of earning income or profit; and

(2) the entity performs active management and operational functions.

(c) Activities performed by the entity include activities performed by persons outside the entity, including independent contractors, to the extent the persons perform services on behalf of the entity and those services constitute all or part of the entity’s trade or business.

(d) An entity conducts an active trade or business if assets, including royalties, patents, trademarks, and other intangible assets, held by the entity are used in the active trade or business of one or more related entities.

(e) For purposes of this section:

(1) the ownership of a royalty interest or a nonoperating working interest in mineral rights does not constitute conduct of an active trade or business;

(2) payment of compensation to employees or independent contractors for financial or legal services reasonably necessary for the operation of the entity does not constitute conduct of an active trade or business; and

(3) holding a seat on the board of directors of an entity does not by itself constitute conduct of an active trade or business.

¹⁸ The REIT exclusion is limited to REITs that do not directly own property (other than the real estate that the REIT occupies for business purposes) and qualified REIT subsidiaries (which do not include partnerships). Tex. Tax Code Ann. § 171.0002(c)(4).

¹⁹ An interpretative question under 2006 H.B. 3 is what types of “trusts” other than grantor trusts, might be considered to be a “legal entity” as that term is used in connection with the definition of “taxable entity.” The Texas Trust Code applies only to “express trusts.” An “express trust” is defined in the Texas Trust Code as “a fiduciary relationship” with respect to property which arises as a manifestation by the settlor of an intention to create the *relationship* and which subjects the person holding title to the property to equitable duties to deal with the property for the benefit of another person.” Recently, the Texas Supreme Court confirmed previous decisions that a trust is not an entity but a relationship. *See, e.g., Huie v. DeShazo*, 922 S.W.2d 920, 926 (Tex. 1996) (holding that “[t]he term ‘trust’ refers not to a separate legal entity but rather to the fiduciary relationship governing the trustee with respect to the trust property[,]” and that treating trust rather than trustee as attorney’s client “is inconsistent with the law of trusts”). There is at least a negative implication in the wording of 2006 H.B. 3, however, that trusts other than “grantor trusts” are taxable entities. Further, a trust is an entity for federal income tax purposes (when a trust applies for a taxpayer identification number, the name of the entity is the name of the trust – not the name of the trustee; the taxpayer name used on a trust’s Form 1041 is the trust’s name).

²⁰ Tex. Tax Code Ann. § 171.0002(c).

²¹ Article 45 of Senate Bill 1 (“2011 S.B. 1”) passed in 2011 Special Session.

²² *See Texas Tax Policy News* (Tex. Comptroller of Pub. Acts. Oct. 2011).

²³ 34 Texas Administrative Code § 3.582 (2008) (Public Finance, Franchise Tax, Margin: Passive Entities) defines federal gross income as: “Gross income as defined in Internal Revenue Code, §61(a).”

partnership allocations from downstream partnerships or LLCs, dividends, interest, royalties, or capital gains from the sale of (i) real estate,²⁴ (ii) securities²⁵ or (iii) commodities. Real estate rentals, as well as other rent and income from working mineral interests, are not passive income sources unless they are classified as “royalties, bonuses, or delay rental income from mineral properties and income from other nonoperating mineral interests.”²⁶ Gain on the sale of tangible personal property is not passive source income. In addition, only non-business trusts, general partnerships and limited partnerships can qualify as passive entities. LLCs and corporations (including S-corps) cannot qualify as passive entities, even if 90% of their income is from qualifying passive sources.

A limited partnership that has income from real estate rents, as well as dividends and interest, may want to consider whether the entity could be split in two in order to isolate the passive income sources into an entity that will qualify as a tax exempt passive entity.²⁷

Comptroller Rule 3.582 mandates that an entity must be the type of entity that may qualify to be passive (i.e., a partnership or trust, and not an LLC) for the entire tax year at issue in order to qualify as passive for such year.²⁸ So for example, if an LLC with substantial real estate rents plans to convert to an LP for a year in which it will liquidate a real estate asset, achieve a major capital gain, and possibly qualify as a passive entity, the LLC will need to complete the conversion to an LP prior to January 1 of such year.

Passive entities cannot be included as part of a combined group, and the owners of passive entities are not allowed to exclude income allocations from the passive entity.²⁹ Rather, if the owners of a passive entity are otherwise “taxable entities,” they will have to re-test to determine their own passive status. The income the owners receive from such a downstream

²⁴ There is some pending discussion of what definition of “real estate” will be used for this purpose. While the Texas Comptroller has long standing definitions for “real estate” under the sales tax chapters of the Texas Tax Code, there is some informal indication that the Internal Revenue Code’s definition of real estate is more appropriate for this purpose. *See, e.g.*, Treas. Reg. 1-897-1(b)(1).

²⁵ Securities only include “non-controlling” interests. 34 T.A.C. § 3.582(b)(10).

²⁶ Tex. Tax Code Ann. § 171.0003(a)(2)(D); *see also* § 171.0003(b)(2) (passive income includes “income received by a nonoperator from mineral properties under a joint operating agreement if the nonoperator is [not] a member of an affiliated group and another member of that group is the operator under the same joint operating agreement”).

²⁷ 2006 H.B. 3 § 22 raised some historical questions about whether or to what extent partnership divisions could be honored. For example, 2006 H.B. 3 § 22(f) provides that when a partnership is divided into two or more partnerships, the resulting partnerships are treated as a “continuation of the prior partnership.” This does not apply to partnerships owned 50% or less by the partners of the former partnership. *See* 2006 H.B. 3 § 22.

²⁸ 34 TEX. ADMIN. CODE § 3.582(g) (stating the “[r]eporting requirement for a passive entity. If an entity meets all of the qualifications of a passive entity **for the reporting period**, the entity will owe no tax; however, the entity must file information to verify that the passive entity qualifications are met each year.”) (*emphasis added*).

²⁹ 34 TEX. ADMIN. CODE § 3.587(c)(4) (2008) (Public Finance, Franchise Tax, Margin: Total Revenue) (stating the total revenue reporting requirements for a passive entity that “[a] taxable entity will include its share of net distributive income from a passive entity, but only to the extent the net income of the passive entity was not generated by any other taxable entity”).

passive entity may qualify as passive source income,³⁰ but the passive entity owner will still have to independently pass the 90% passive source test. Caution and care should be taken with respect to passive entity planning, and one rule of thumb is that passive entity status will generally not be of any benefit to the extent that there are intermediary taxable entities (i.e. corporations or LLCs) between a passive entity and its ultimate natural person owners.

(c) LLPs. In 2007 the Texas Legislature in 2007 H.B. 3928 “clarified” (or expanded) the scope of the Margin Tax to apply to LLPs.³¹ Also, the Comptroller has determined that LLPs can qualify to be passive entities if they otherwise meet the 90% test for passive revenue.³²

(d) Prior Chapter 171 Exemptions. The Margin Tax preserves the exemptions previously available under the Texas franchise tax for “an entity which is not a corporation but that because of its activities, would qualify for a specific exemption ... if it were a corporation” to the extent it would qualify if it were a corporation.³³

(e) \$1 Million Minimum Deduction Beginning 2014. In the 2013 Legislative Session, HB 500 amended Section 171.101(a) and (b) of the Tax Code effective January 1, 2014 to allow for a minimum deduction of up to \$1 million from an entity’s taxable margin.³⁴ The \$1 million deduction passed in the 2013 Legislature change does not include a statutory expiration date. The versions of the Margin Tax³⁵ effective through 2015 have included revenue thresholds ranging from \$600,000 up to \$1,080,000 below which the Margin Tax simply does not apply. These taxability thresholds do not act as deductions and formerly created what was being colloquially referred to as a “tax cliff.” Beginning in 2014 taxable entities, or combined groups, with \$1,080,000 or less in gross revenues will not be subject to the Margin Tax, and those with

³⁰ 34 TEX. ADMIN. CODE § 3.582(c)(2)(B) (stating the income qualifications for a passive entity as “[passive income includes] distributive shares of partnership income”).

³¹ 2007 H.B. 3928 § 2 amended TEX. TAX CODE ANN. § 171.0002(a) to add “limited liability partnership” to the statutory definition of “taxable entity.”

³² 34 TEX. ADMIN. CODE § 3.582(c)(1)(C).

³³ *See, e.g.*, TEX. TAX CODE ANN. § 171.088.

³⁴ *See* Section 6 of HB 500 83rd Tex. Leg. Session.

³⁵ *See e.g.*, 2009 H.B. 4765 by Rep. Rene Oliveira (D-Brownsville), *available at* <http://www.legis.state.tx.us/BillLookup/Text.aspx?LegSess=81R&Bill=HB4765> (increased the small business exemption from the franchise tax from \$300,000 to \$1 million for 2010 and 2011 tax years, contingent on the passage of an increase in the smokeless tobacco tax; the increased exemption sunsets on December 31, 2011; thereafter, the exemption was reduced from \$1 million to \$600,000 and the reduction was made contingent on the passage of an increase in the smokeless tobacco tax; 2009 H.B. 4765 was effective January 1, 2010); 2009 H.B. 2154 Rep. Al Edwards (D-Houston), *available at* <http://www.legis.state.tx.us/BillLookup/Text.aspx?LegSess=81R&Bill=HB2154> (provided the smokeless tobacco tax required by 2009 H.B. 4765, which was intended to raise new revenue by increasing tobacco taxes to offset some of the fiscal impact of 2009 H.B. 4765). In addition there is a staggered phase-in of the Margin Tax for taxpayers with annual revenues greater than \$600,000 and less than \$900,000.

gross revenues above \$1 million will receive up to a minimum \$1 million deduction. The 2015 Texas Legislature did not alter the \$1,000,000 deduction.³⁶

(f) Basic Calculation and Rates. Through 2015, the basic calculation of the Margin Tax is a taxable entity's (or unitary group's) gross receipts less the greatest of: (a) 30% of gross revenue; or (b) compensation or (c) cost of goods sold ("COGS"). Initially, the election to use COGS or compensation as the deduction had to be made on or before the due date of the return and such election could not be amended thereafter.³⁷ In a rare reversal of policy, the Texas Comptroller has reversed its position and now allows post-due date amendments to the COGs vs. compensation deduction.³⁸ An affiliated group must choose one type of deduction to apply to the entire group. The "tax base" is apportioned to Texas using a single-factor gross receipts apportionment formula with no throwback rule – Texas gross receipts divided by aggregate gross receipts. The tax rate applied to the Texas portion of the tax base through 2015 is .95% for all taxpayers except a narrowly defined group of retail and wholesale businesses which pay a .475% rate.³⁹ For reports due on or after January 1, 2016, the tax rate drops to .75% for most taxpayers (.375 % for wholesale and retail).⁴⁰ There is a safety net so that the "tax base" for the Margin Tax may not exceed 70% of a business's total revenues.⁴¹ However, it is possible for an entity to owe Margin Tax in any given year even if it is reporting a loss for federal income tax purposes and has a negative cash flow. There is also an alternative "EZ" calculation based on a .331% tax rate, with no deductions for taxpayers with less than \$20,000,000 in gross revenue.⁴² Entities pay the Margin Tax on a "unitary combined basis" (i.e., affiliated groups of entities would in effect be required to pay taxes on a consolidated basis). Thus, the internal partnership structure described below under the heading "6. Internal Partnerships Will Not Work Under Margin Tax" would no longer work as described.⁴³

(g) Gross Revenue Less (x) Compensation or (y) Cost of Goods Sold. For purposes of the Margin Tax, a taxable entity's total revenue is generally total income as reported on IRS Form 1120 (for corporate entities),⁴⁴ or IRS Form 1065 (for partnerships and other pass-through entities),⁴⁵ plus dividends, interest, gross rents and royalties, and net capital gain income,⁴⁶ minus

³⁶ Tex. Tax Code § 171.002(d)(2).

³⁷ See, e.g., Texas Comptroller of Public Accounts Hearing 104,076 (Accession No. 201102012H, Feb. 23, 2011).

³⁸ <http://aixtcp.cpa.state.tx.us/opensdocs/open32/201102012h.html>.

³⁹ Article 51 of 2011 S.B. 1 from the 2011 Special Session extended the .5% rate to "apparel rental activities classified as Industry 5999 or 7299" of the 1987 SIC Manual. Tex. Tax Code § 171.0001(12)(B) (effective January 1, 2012).

⁴⁰ HB 32 84th Tex. Leg. Session (amending Tex. Tax Code § 171.002).

⁴¹ See *id.* § 171.101.

⁴² *Id.* § 171.1016.

⁴³ See *infra* note 128 and related text.

⁴⁴ *Id.* § 171.1011(c)(1).

⁴⁵ *Id.* § 171.1011(c)(2).

⁴⁶ *Id.* § 171.1011(c)(1)(A).

bad debts, certain foreign items, and income from related entities to the extent already included in the margin tax base.⁴⁷

(h) Gross Revenue. The original version of the Margin Tax from 2006 H.B. 3 included a very short and specific list of “flow through” items which are excluded from gross receipts: (A) flow-through funds that are mandated by law or fiduciary duty to be distributed to other entities (such as sales and other taxes collected from a third party and remitted to a taxing authority);⁴⁸ (B) the following flow-through funds that are required by contract to be distributed to other entities: (i) sales commissions paid to non-employees (including split-fee real estate commissions);⁴⁹ (ii) subcontracting payments for “services, labor, or materials in connection with the actual or proposed design, construction, remodeling, or repair of improvements on real property or the location of the boundaries of real property”;⁵⁰ and (iii) law firms may exclude the amounts they are obligated to pay over to clients and referring attorneys, matter specific expenses, and pro-bono out-of-pocket expenses not to exceed \$500 per case;⁵¹ (C) the federal tax basis of securities and loans underwritten or sold;⁵² (D) lending institutions may exclude loan

⁴⁷ *Id.* § 171.1011(c)(1)(B).

⁴⁸ *Id.* § 171.1011(f).

⁴⁹ *Id.* § 171.1011(g)(1).

⁵⁰ *Id.* § 171.1011(g)(3). Payments to subcontractors (apart from very limited express exclusions) are not excludable from gross receipts for Margin Tax calculations. Thus, if a client specifically engaged an accounting firm in Texas to hire other accounting firms and pay for tax filings in other states or countries and include the amount in the Texas accountant’s bill as a reimbursable expense, the expense reimbursement would be included in the Texas accounting firm’s gross receipts. The consequence is the Texas firms will increasingly ask their clients to pay significant out of pocket expenses directly.

⁵¹ Texas Tax Code § 171.1011(g-3) allows legal service providers to exclude flow-through receipts as follows:

(g-3) A taxable entity that provides legal services shall exclude from its total revenue:

(1) to the extent included under Subsection (c)(1)(A), (c)(2)(A), or (c)(3), the following flow-through funds that are mandated by law, contract, or fiduciary duty to be distributed to the claimant by the claimant’s attorney or to other entities on behalf of a claimant by the claimant’s attorney:

(A) damages due the claimant;

(B) funds subject to a lien or other contractual obligation arising out of the representation, other than fees owed to the attorney;

(C) funds subject to a subrogation interest or other third-party contractual claim; and

(D) fees paid an attorney in the matter who is not a member, partner, shareholder, or employee of the taxable entity;

(2) to the extent included under Subsection (c)(1)(A), (c)(2)(A), or (c)(3), reimbursement of the taxable entity’s expenses incurred in prosecuting a claimant’s matter that are specific to the matter and that are not general operating expenses; and

(3) \$500 per pro bono services case handled by the attorney, but only if the attorney maintains records of the pro bono services for auditing purposes in accordance with the manner in which those services are reported to the State Bar of Texas.

⁵² Tex. Tax Code §§ 171.1011(g)(2) and 171.1011(g-2).

principal repayment proceeds;⁵³ (E) dividends and interest received from federal obligations;⁵⁴ (F) reimbursements received by a “management company”⁵⁵ for specified costs incurred in its conduct of the active trade or business of a managed entity, including wages and compensation; and (G) payments received by a staff leasing services company from a client company for wages, payroll taxes on those wages, employee benefits, and workers’ compensation benefits for the assigned employees of the client company.⁵⁶

Health care providers⁵⁷ may generally exclude payments received under the Medicaid, Medicare, Children’s Health Insurance Program (“CHIP”), workers’ compensation, the TRICARE military health system, the Indigent Health Care and Treatment Act, as well as the actual costs of “uncompensated care.”⁵⁸ Health care institutions⁵⁹ may exclude 50%⁶⁰ of the public reimbursement program revenues described above. Rulemaking by the Comptroller will be important with respect to these exclusions, because there are currently no means by which to trace Medicare funds to the actual service providers.

Any taxable entity may exclude revenues received from oil or gas produced during dates certified by the Comptroller from (1) an oil well designated by the Railroad Commission of Texas or similar authority of another state whose production averages less than 10 barrels a day over a 90-day period; and (2) a gas well designated by the Railroad Commission of Texas or similar authority of another state whose production averages less than 250 mcf a day over a 90-day period.⁶¹ The Comptroller is required to certify dates during which the monthly average closing price of West Texas Intermediate crude oil is below \$40 per barrel and the average

⁵³ *Id.* § 171.1011(g-1).

⁵⁴ *Id.* § 171.1011(m). “Federal obligations” are defined in Texas Tax Code § 171.1011(p)(1) to include stocks and other direct obligations of, and obligations unconditionally guaranteed by, the United States government and United States government agencies.

⁵⁵ *Id.* § 171.1011(m)(1). “Management company” is defined in Texas Tax Code § 171.0001(11) as any limited liability entity that conducts all or part of the active trade or business of another entity in exchange for a management fee and reimbursement of specified costs.

⁵⁶ “Staff leasing services company” for these purposes has the meaning set forth in § 91.001 of the Texas Labor Code. TEX. LAB. CODE ANN. § 91.001 (Vernon 2010).

⁵⁷ “Health care providers” are defined in Texas Tax Code § 171.1011(p)(3) as “a taxable entity that participates in the Medicaid program, Medicare program, Children’s Health Insurance Program (CHIP), state workers’ compensation program, or TRICARE military health system as a provider of health care services.”

⁵⁸ Tex. Tax Code § 171.1011(n).

⁵⁹ *Id.* § 171.1011(p)(2). “Health care institutions” are defined to include ambulatory surgical centers; assisted living facilities licensed under Chapter 247 of the Health and Safety Code; emergency medical service providers; home and community support services agencies; hospices; hospitals; hospital systems; certain intermediate care facilities for mentally retarded persons; birthing centers; nursing homes; end stage renal disease facilities; or pharmacies.

⁶⁰ *Id.* § 171.1011(o).

⁶¹ *Id.* § 171.1011(r).

closing price of gas is below \$5 per MMBtu, as recorded on the New York Mercantile Exchange (NYMEX).⁶²

Article 45 of 2011 S.B. 1 from the 2011 Special Session allows certain “live event promotion company[ies]” to exclude payments to artists.⁶³ Article 45 also allows qualified “courier and logistics company[ies]” to exclude certain subcontracting payments to non-employees performing delivery services.⁶⁴

Sections 7 and 8 of H.B. 500 from the 2013 Texas Legislature allow new exclusions from revenue for certain: (i) pharmacy network reimbursements; (ii) aggregate and barite transport subcontracting payments; (iii) landman subcontracting service payments; (iv) costs of vaccines; (v) waterway transport service company expenses; and (vi) revenues derived from motor carrier taxes and fees.⁶⁵

(i) The Compensation Deduction. For purposes of the Margin Tax, “compensation” includes “wages and cash compensation” as reported on the Medicare wages and tips box of IRS Form W-2. Section 171.101(a)(1) allows a taxpayer to include in the “compensation” deduction the cost of all benefits to the extent deductible for federal income tax purposes.⁶⁶ It also includes “net distributive income” from partnerships, limited liability companies, and S Corporations to natural persons,⁶⁷ plus stock awards and stock options as well as workers compensation benefits, health care, and retirement to the extent deductible for federal income tax purposes.⁶⁸ The deduction for wages and cash compensation for the return due May 15, 2015 may not exceed \$350,000 plus benefits that are deductible for federal income tax purposes for any single person.⁶⁹ Compensation apparently does not include social security or Medicare contributions, and such amounts apparently are not otherwise deductible for Margin Tax purposes.

(j) The Cost of “Goods” Sold Deduction. Under the Margin Tax, “goods” means real or tangible personal property sold in the ordinary course of business;⁷⁰ the term does not include provision of services. As a result, most service businesses (e.g., accounting, law and engineering firms) will not have a cost of goods sold and are relegated to sole reliance on the compensation deduction.

⁶² *Id.* § 171.1011(s).

⁶³ *Id.* § 171.1011(g-5) (effective January 1, 2012).

⁶⁴ *Id.* § 171.1011(g-7) (effective January 1, 2012).

⁶⁵ *See* Sections 7 and 8 of H.B. 500 83rd Tex. Leg. Session (effective for reports due on or after Jan. 1, 2014).

⁶⁶ *See Winstead, P.C. vs. Susan Combs, Comptroller of Public Accounts of the State of Texas, and Greg Abbott, Attorney General of the State of Texas*, Cause No. D-1-GN-12-000141 (Dist. Ct. of Travis County, 201st Judicial Dist. of Texas, Feb. 7, 2013) (finding certain limitations in Comptroller Rule 3.589(c)(2) invalid).

⁶⁷ *Id.* § 171.1013(a)(1) & (2).

⁶⁸ *Id.* § 171.1013(a)(3).

⁶⁹ *Id.* § 171.1013(c).

⁷⁰ *Id.* § 171.1012(a)(1).

The term “cost of goods sold” is defined to include the direct costs of acquiring or producing goods, including labor costs, processing, assembling, packaging, inbound transportation, utilities, storage, control storage licensing and franchising costs, and production taxes.⁷¹ Certain indirect costs for production facilities, land and equipment, such as depreciation, depletion, intangible drilling and dry hole costs, geological and geophysical costs, amortization, renting, leasing, repair, maintenance, research, and design are also included.⁷² The “cost of goods sold” definition does not include selling costs, advertising, distribution and outbound transportation costs, interest or financing costs, income taxes or franchise taxes.⁷³ Up to 4% of administrative and overhead expenses may be included in “cost of goods sold” to the extent they are allocable to the costs of acquiring or producing goods.⁷⁴ The “cost of goods sold” must be capitalized to the extent required by I.R.C. § 263A.⁷⁵

For reports due on or after January 1, 2014, Section 9 of H.B. 500 from the 2013 Texas Legislature includes a defined list of operations and depreciation costs of certain pipelines within the definition of COGS. In addition, movie theaters are expressly authorized to deduct the cost of the films they show.⁷⁶

(k) Transition and Filing. The Margin Tax was phased in commencing on January 1, 2007. The Texas franchise tax remained in place for 2006, with the May 2007 tax payment based on business in 2006. The Margin Tax was effective January 1, 2007 and applies to business done after that date; however, the May 2007 franchise tax payment was based on the old franchise tax for business in 2006. The Margin Tax payments due in 2008 and subsequent years are based on business in the preceding calendar year.

Regular annual Margin Tax returns are due on May 15⁷⁷ of each year, and are based on financial data from the previous calendar year. The first Margin Tax returns were originally due on May 15, 2008, but on April 22, 2008, the Comptroller extended that date for 30 days in recognition of the complexity of the Margin Tax and the newness of enhanced electronic reporting methods.⁷⁸ The Margin Tax returns are based on financial data for the preceding calendar year.

(l) Unitary Reporting. In another change from the franchise tax which did not provide for consolidated tax reporting, the Margin Tax requires Texas businesses to file on a

⁷¹ *Id.* § 171.1012(c).

⁷² *Id.* § 171.1012(c) and (d).

⁷³ *Id.* § 171.1012(e).

⁷⁴ *Id.* § 171.1012(f).

⁷⁵ *Id.* § 171.1011(g).

⁷⁶ See Section 9 of H.B. 500 83rd Tex. Leg. Session (effective for reports due on or after Jan. 1, 2014).

⁷⁷ *Id.* § 171.151(c).

⁷⁸ See 2006 H.B. 3, § 22; Texas Comptroller of Public Accounts press release issued April 22, 2008, available at <http://www.window.state.tx.us/news2008/080422-ftaxextension.html>.

unitary and combined basis. An affiliated group of entities in a “unitary business”⁷⁹ must file a combined return including all taxable entities within the group.⁸⁰ The unitary group includes all affiliates⁸¹ with a common owner (i.e., greater than 50% owned),⁸² and the group includes entities with no nexus in Texas.⁸³

(m) Combined Reporting. The Margin Tax statute literally applies its combined reporting standard of greater than 50% ownership to one or more “common owner or owners.”⁸⁴ The application of this standard proved unworkable, and the Comptroller’s Rule 3.590⁸⁵ now limits the application of the combined reporting requirement to entities with greater than 50% ownership or control held directly or indirectly by a single owner. The only attribution rule applies to interests owned or controlled by a husband and wife.⁸⁶

Comptroller Rule 3.590 includes the following examples of determining the scope of an affiliated group:

(i) Corporation A owns 10% of Corporation C and 60% of Corporation B, which owns 41% of Corporation C. Corporation A has a controlling interest in Corporation B and a controlling interest in Corporation C of 51% of stock ownership because it has control of the stock owned by Corporation B.

(ii) Corporation A owns 10% of Limited Liability Company C and 15% of Corporation B, which owns 90% of Limited Liability Company C. Corporation A does not have controlling interest in Limited Liability Company C and does not have a controlling interest in Corporation B. Corporation B has a controlling interest in Limited Liability Company C.

(iii) Individual A owns 100% of 10 corporations, each of which owns 10% of Partnership B. Individual A has a controlling interest in each of the ten corporations and in Partnership B.

⁷⁹ Texas Tax Code § 171.0001(17) defines a “unitary business” as “a single economic enterprise that is made up of separate parts of a single entity or of a commonly controlled group of entities that are sufficiently interdependent, integrated, and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts.”

⁸⁰ *Id.* § 171.1014.

⁸¹ Section 171.0001(1) of the Texas Tax Code defines an “affiliated group” as “a group of one or more entities in which a *controlling interest* is owned by a common owner or owners, *either corporate or noncorporate*, or by one of more of the member entities.” [*emphasis added*]

⁸² *Id.* § 171.0001(8).

⁸³ *See id.* § 171.1014(c).

⁸⁴ *Id.* § 171.0001(1).

⁸⁵ 34 TEX. ADMIN. CODE § 3.590 (Public Finance, Margin: Combined Reporting) (Effective January 1, 2008).

⁸⁶ *Id.* § 3.590 (b)(4)(E).

(iv) Corporation A holds a 70% interest in Partnership B that owns 60% of Limited Liability Company C. Corporation A owns the remaining 40% of Limited Liability Company C. Corporation A owns a controlling interest in Partnership B and a 100% controlling interest in Limited Liability Company C.⁸⁷

The Comptroller's Rule 3.590 defines "controlling interest" for determining the combined reporting standard for a corporation as, "either more than 50%, owned directly or indirectly, of the total combined voting power of all classes of stock of the corporation, or more than 50% owned directly or indirectly, of the beneficial ownership interest in the voting stock of the corporation."⁸⁸ This test is clearly based on control. In contrast, with respect to a partnership or trust, Comptroller Rule 3.590 defines controlling interest as, "more than 50%, owned, directly or indirectly, of the capital, profits, or beneficial interest in the partnership, association, trust, or other entity."⁸⁹ The controlling interest standard for partnerships and trusts appears to be more focused on economic or beneficial ownership rather than control. The Comptroller Rule 3.590 goes on to state that with respect to a limited liability company, controlling interest means "either more than 50%, owned directly or indirectly, of the total membership interest of the limited liability company or more than 50%, owned directly or indirectly, of the beneficial ownership interest in the membership interest of the limited liability company."⁹⁰

One issue raised by Comptroller Rule 3.590 is which party to a trust agreement (settlor, trustee, or beneficiary) should be considered to hold the "beneficial interest" for purposes of the controlling interest standard. One might conclude under state law that the "beneficiary" holds the "beneficial interest." But, one must consider that in other contexts the term beneficial interest refers to control rather than economic ownership.⁹¹ The Comptroller may well be inclined to take the position that "controlling interest" should be determined by control rather than mere economic ownership.

The combined group does not include entities with 80% or more of their property and payroll outside the United States.⁹² Passive entities or exempt entities are not part of the group.⁹³

⁸⁷ *Id.* § 3.590.

⁸⁸ 34 T.A.C. § 3.590(b)(4)(A)(i).

⁸⁹ 34 T.A.C. § 3.590(b)(4)(A)(ii).

⁹⁰ 34 T.A.C. § 3.590(b)(4)(A)(iii).

⁹¹ *See* Rule 13d-3(a) promulgated by the Securities and Exchange Commission under the Securities Exchange Act of 1934, as amended, which provides as follows:

(a) For the purposes of sections 13(d) and 13(g) of the Act a beneficial owner of a security includes any person who, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise has or shares:

(1) Voting power which includes the power to vote, or to direct the voting of, such security; and/or,

(2) Investment power which includes the power to dispose, or to direct the disposition of, such security.

⁹² Tex. Tax Code § 171.1014(a).

⁹³ 34 T.A.C. § 3.590(b)(2)(B) & (F).

The affiliated group is a single taxable entity for purposes of filing the Margin Tax return, and the combined return is designed to be the sum of the returns of the separate affiliates. The group must make an election to choose either the (i) cost of goods sold deduction; or (ii) the compensation deduction for all of its members.⁹⁴ In order to avoid double taxation the combined group may exclude items of total revenue received from a member of the group to the extent such revenue is already in the tax base of an upper tier group member.⁹⁵

(n) Apportionment. The Margin Tax is apportioned using a single-factor gross receipt formula (Texas gross receipts divided by aggregate gross receipts).⁹⁶ Receipts that are excluded from the tax base must also be excluded from gross receipts for apportionment purposes.⁹⁷

Texas gross receipts include receipts from the sale of tangible personal property delivered or shipped to a buyer in this state, services performed in this state (regardless of customer location), the use of a patent, copyright, trademark, franchise, or license in this state, sale of real property in this state (including royalties from minerals) and other business done in this state.⁹⁸ Only Texas gross receipts from those entities within the group which have nexus in Texas are included in the calculation of Texas receipts (this is sometimes referred to as the “*Joyce*” rule).⁹⁹ Sales to states in which the seller is not subject to an income tax are not deemed to be a Texas receipt (i.e., no throwback rule).¹⁰⁰

Aggregate gross receipts include the gross receipts (as described above) of each taxable entity in the combined group without regard to whether an individual entity has nexus with Texas.¹⁰¹ If a taxable entity sells an investment or capital asset, the taxable entity’s gross receipts from its entire business for taxable margin includes only the net gain from the sale.¹⁰²

(o) Credits / NOLs. Comptroller Rule 3.594 (effective January 1, 2008) describes the limited ability of a taxpayer to utilize its net business operating loss carryforwards (“NOLs”) as a credit against the Texas margin tax.¹⁰³ One initial qualification is that any business losses upon which NOLs are based must have been used to offset any positive amount of earned surplus even in years when no tax was due.¹⁰⁴ In addition, taxpayers must submit a notice of intent to preserve the right to claim the temporary credit for business loss carryforwards with the first

⁹⁴ *Id.* § 171.1014(d).

⁹⁵ *Id.* § 171.1014(c)(3).

⁹⁶ *Id.* § 171.106(a).

⁹⁷ *Id.* § 171.1055(a).

⁹⁸ *Id.* § 171.103(a).

⁹⁹ *Id.* § 171.103(b).

¹⁰⁰ *See* deletion from former TEX. TAX CODE ANN. § 171.103(a)(1) (amended 2006).

¹⁰¹ *Id.* § 171.105(c).

¹⁰² *Id.* § 171.105(b).

¹⁰³ 34 TEX. ADMIN. CODE § 3.594 (2007) (Public Finance, Franchise Tax, Margin: Temporary Credit).

¹⁰⁴ *Id.*

report due from a taxable entity after January 1, 2008, on a form prescribed by the Comptroller.¹⁰⁵ A taxable entity may only claim the credit if the entity was subject to franchise tax on May 1, 2006.¹⁰⁶ The of the right to claim the NOL credit may not be transferred to another entity and changes to the membership of a combined group can prejudice the right to utilize the NOL credit.¹⁰⁷

“The election to claim the credit shall be made on each report originally due on or after January 1, 2008 and before September 1, 2027.”¹⁰⁸ If a taxpayer is eligible to use its NOLs as a Margin Tax credit, then for report years 2008–2017, the credit is the business loss carryforward amount x 2.25% x 4.5%.¹⁰⁹ For report years 2018–2027, the credit for the business loss carryforward amount x 7.75% x 4.5%.¹¹⁰

(p) New R&D Credit From 2013 Texas Legislature. H.B. 800 from the 2013 Texas Legislature allows a taxpayer¹¹¹ to elect to take: (i) sales tax exemption for “tangible personal property directly used in qualified research;”¹¹² or (ii) a Texas franchise tax credit for certain “qualified research” expenditures. The definition for “qualified research” is tied to the definition in Section 41 of the Internal Revenue Code¹¹³ and is further conditioned by the requirement that the qualified research must be conducted within Texas.¹¹⁴ If the taxpayer elects to take a franchise tax credit for qualified research expenditures rather than utilize the sales tax exemption, the amount of the credit is:

$5\%^{115} \times ((\text{qualified research expenditures in the tax report year}) - (50\% \text{ of the average qualified research expenditures during the three tax periods preceding the tax report}))$

¹⁰⁵ *Id.*

¹⁰⁶ *Id.*

¹⁰⁷ *Id.*

¹⁰⁸ *Id.*

¹⁰⁹ *Id.*

¹¹⁰ *Id.*

¹¹¹ Note that if the taxpayer is a member of a combined group, and one member of the combined group elects to use the sales tax exemption on R&D equipment purchases in a given report year, then all members of the combined group are prohibited from taking the franchise tax credit for that year. Section 2 of H.B. 800 83rd Tex. Leg. Session;Tex. Tax Code Section 171.653.

¹¹² See Section 2 of H.B. 800 83rd Tex. Leg. Session; Tex. Tax Code Section 151.3182(b) (effective Jan. 1, 2014).

¹¹³ See Section 2 of H.B. 800 83rd Tex. Leg. Session (effective Jan. 1, 2014); Tex. Tax Code Section 151.3182(a)(3).

¹¹⁴ See Section 3 of H.B. 800 83rd Tex. Leg. Session (effective Jan. 1, 2014); Tex. Tax Code Section 171.651(3).

¹¹⁵ A higher credit amount of 6.25% is allowed for contracts with institutions of higher education.

The R&D tax credit may not exceed 50% of the amount of the franchise tax due in any given report year¹¹⁶ before the application of any other credits, but unused credits may be carried forward for up to 20 years.¹¹⁷

(q) New Relocation Deduction From 2013 Texas Legislature. Section 13 of H.B. 500 from the 2013 Texas Legislature adds Section 171.109 to the Texas Tax Code, and the new Section allows a taxable entity that does not have nexus with Texas¹¹⁸ to deduction from its apportioned margin “relocation costs incurred in relocating the taxable entity’s main office or other principal place of business to this state from another state” on or after September 1, 2013.

(r) New Historic Structure Rehabilitation Credit From 2013 Legislature. Section 14 of H.B. 500 from the 2013 Texas Legislature provides for a franchise tax credit for the rehabilitation of certain historic structures.¹¹⁹ The rehabilitation credit takes effect January 1, 2015. The amount of the credit may not exceed 25% of the total eligible coss and expenses incurred in the qualifying rehabilitation project.¹²⁰ The credit in any one year may not exceed the franchise tax due for the report year, but may be carried forward for up to five consecutive reports.¹²¹

(s) Administration and Enforcement. The Comptroller has rulemaking authority with respect to the Margin Tax and has prepared a worksheet illustrating the calculation of taxable margin on a separate entity basis.¹²²

(t) Effect of Margin Tax on Choice of Entity Decisions. The enactment of the Margin Tax changes the calculus for entity selections, but not necessarily the result. The LLC has become more attractive for all business that are not likely to ever qualify as exempt “passive entities” because an LLC can elect to be taxed as a corporation or partnership for federal income tax purposes. However, the uncertainties as to an LLC’s treatment for self-employment purposes can restrict its desirability in some situations.¹²³

4. Constitutionality of Margin Tax Upheld in *Allcat*. On November 28, 2011, the Texas Supreme Court reported its *Allcat* decision¹²⁴ that the Texas franchise, tax does not does

¹¹⁶ Tex. Tax Code Section 171.658 (added by H.B. 800 2013 Tex. Legislature).

¹¹⁷ Tex. Tax Code Section 171.659 (added by H.B. 800 2013 Tex. Legislature).

¹¹⁸ In addition, the entity must not be part of a unitary affiliated group in which another member is doing business in Texas. See Section 13 H.B. 500 2013 Texas Legislature adding Section 171.109 to the Texas Tax Code (effective Sep. 1, 2013).

¹¹⁹ See Section 14 H.B. 500 2013 Texas Legislature adding Section 171.901 through 171.909 to the Texas Tax Code (effective Jan. 1, 2015).

¹²⁰ Tex. Tax Code Section 171.905 (effective Jan. 1, 2015).

¹²¹ Tex. Tax Code Section 171.906 (effective Jan. 1, 2015).

¹²² The Comptroller’s Margin Tax calculation worksheet is called “Franchise Tax Online Calculator” on the Comptroller’s website and may be found at <http://www.window.state.tx.us/taxinfo/taxforms/HB3Calc.pdf>.

¹²³ See Appendix A Federal Taxation of Entities (“Appendix A”) at F.3 Taxation of LLCs – Self-Employment Tax.

¹²⁴ *In re Allcat Claims Service, L.P.*, No. 11-0589, 2011 WL 6091134 (Tex. Nov. 28, 2011).

not violate the Texas Constitution's so-called "Bullock Amendment" which prohibits "a tax on the net incomes of natural persons."¹²⁵ Allcat Claims Service, L.P., and one of its individual partners, John Weakly, filed their case on July 29, 2011 asserting that the margin tax was effectively a personal income tax as it applied to the income of partnerships owned by natural persons. Relying heavily on the separate legal entity status of partnerships under Texas law, the Texas Supreme Court ruled that the franchise tax is a tax **on business entities**, not on natural persons, and consequently that the margin tax does not violate the "Bullock Amendment." Prior to *Allcat*, many commentators and public officials considered the Margin Tax to be an income tax, particularly in the case of a partnership providing professional services (e.g., accounting, engineering, law or medical).¹²⁶

¹²⁵ The Bullock Amendment to Texas Constitution article 8, section 24(a),¹²⁵ provides:

A general law enacted by the legislature that imposes *a tax on the net incomes of natural persons, including a person's share of partnership and unincorporated association income*, must provide that the portion of the law imposing the tax not take effect until approved by a majority of the registered voters voting in a statewide referendum held on the question of imposing the tax. The referendum must specify the rate that will apply to taxable income as defined by law. [Emphasis added]

¹²⁶ See Nikki Laing, *An Income Tax by Any Other Name is Still an Income Tax: The Constitutionality of the Texas "Margin" Tax as Applied to Partnerships and Other Unincorporated Associations*, 62 BAYLOR L. REV. 1 (2010). Former Comptroller Carole Keeton Strayhorn in an April 21, 2006 letter to Greg Abbott, which can be found at <http://tinyurl.com/m6lueye> wrote that portions of 2006 H.B. 3 are unconstitutional: "Taxing income from partnerships is strictly prohibited by the Texas Constitution, and I believe when this portion of H.B. 3 is challenged in court, the State will lose." In a letter (dated April 21, 2006) (on file with author) to the Attorney General of Texas requesting a formal opinion whether 2006 H.B. 3 requires voter approval under the Bullock Amendment, Comptroller Strayhorn wrote:

The literal wording of the Bullock Amendment is that a tax on the net income of natural persons, including a person's share of partnership or unincorporated association income, must include a statewide referendum. The phrase "a person's share" logically modifies the words "income of natural persons" and read literally and as an average voter would understand it, this provision would mean that, unless approved by the voters, no tax may be levied on any income that a person receives from any unincorporated association. That interpretation is entirely consistent with the caption and ballot language of SJR 49, which refer to a prohibition against a "personal income tax."

"A person's share" of the income of an unincorporated association, whether it be a limited partnership or a professional association, is determined first by the agreement between the principals, and absent one, is governed by the statutes that apply to those entities. The "share" does not have to be predicated on the "net income" of the unincorporated association. However calculated or derived, the share received by the natural person that becomes a part of his or her "net income" cannot be taxed without voter approval, period.

An alternative interpretation of the partnership/unincorporated association proviso for which supporters of the legislation may contend would read into the proviso the word "net" so that, they would say, to trigger the referendum the tax would have to be on a person's share of partnership or unincorporated association "net income." In other words, under this much more restrictive interpretation, only a tax on the net income of a partnership or unincorporated association, from which a natural person received a share, would trigger the required referendum. Interpolation of words into a constitutional provision should not be utilized where it would defeat the overriding intent evidenced by the provision. *Mauzy v. Legislative Redistricting Board*, 471 S. W. 2d 570 (Tex. 1971). Interpolation of the word "net" in this proviso materially changes its meaning and would not be consistent with the caption and ballot language. The electorate voted on whether a personal income tax was to be approved

The *Allcat* decision affords Texas lawmakers more flexibility to analyze what types of taxes would be permissible under the Bullock Amendment and additional latitude in crafting revisions to address continuing complaints about the margin tax. For example, applying the 1991 franchise tax base to most types of business entities, even if expressly linked to net income as reported for federal income tax purposes, should be permissible under the *Allcat* standard.

Because the franchise tax exclusion for partnerships was a factor to be considered in deciding whether to form a corporation, LLC or partnership, the enactment of the Margin Tax is a material consideration in the entity selection analysis and removes one factor favoring partnerships in a choice of entity analysis.

by the Legislature without voter approval, and nothing suggests that it is only taxation of “net income” of the unincorporated association that was so objectionable as to require further voter approval.

* * *

This provision means that if the tax is determined by deducting from gross income any items of expense that are not specifically and directly related to transactions that created the income, it is an income tax. And, if it is an income tax, it is within the Bullock Amendment. Proposed Section 171.1012 (relating to the cost of goods sold deduction) and 171.1013 (relating to the compensation deduction) clearly include indirect and overhead costs of production and/or compensation that make the margin tax an income tax under this preexisting Texas definition found in Chapter 141, thereby invoking the Bullock Amendment.

* * *

Certainly it is the case that not all expenses are deducted under the margin tax concept, and thus under some technical accounting definitions the margin tax would not be on “net income” as that term is sometimes used in accounting parlance (i.e., the concluding item on an income statement). But the amendment contains no link to accounting standards or definitions and it hardly could be said that an average voter in 1993 knew about, or cared about, the technicalities of accounting definitions—no tax on his or her net income, including on income that is received from partnerships or unincorporated associations, was what was being prohibited, technicalities aside.

Proponents of the margin tax will no doubt assert that the margin tax does not invoke Article VIII, Sec. 24(a) because the tax would be assessed against entities, not against individuals, and particularly entities that under the law provide liability insulating protection to their owners or investing principals just like corporations. But as noted, the partnership/unincorporated association proviso of the Bullock Amendment refers plainly and simply to “a person’s share” of the income of an unincorporated association as triggering the referendum. Whether the tax is directly on an entity is irrelevant if the only inquiry is whether there is ultimately a tax levied on “a person’s share” of some distribution.

* * *

I believe the proposed margin tax would likewise require a referendum under Article VIII, Sec. 24(a), precluding any adoption absent voter approval.

I also seek your opinion of whether the disparate tax rates found in this legislation as proposed are permissible. As presently conceived, retailers and wholesalers would pay the margin tax at the rate of ½ of 1 percent on their chosen tax base, and all other taxable entities would pay at the rate of 1 percent.

An obvious issue is whether any rational basis exists for taxing retailers and wholesalers at a rate substantially different from the rate that would apply to all other businesses. I question whether this approach is valid based on fundamental principles of equal treatment under the law.

5. Classification of Margin Tax Under GAAP. The Margin Tax is classified as an income tax in financial statements prepared in accordance with GAAP.¹²⁷ The minutes of FASB's August 2, 2006 meeting reflect that FASB decided not to add a project to its agenda that would provide guidance on whether the Margin Tax is an income tax that should be accounted for in accordance with FASB Statement No. 109, *Accounting for Income Taxes*, "because the tax is based on a measure of income." These minutes further reflect FASB's TA&I Committee had "concluded that the [Margin] Tax was an income tax that should be accounted for under Statement 109 and that there would not be diversity in the conclusions reached by preparers, auditors, and regulators on whether the [Margin] Tax was an income tax.

6. Internal Partnerships Will Not Work Under Margin Tax. Many Texas based corporations (whether or not incorporated in Texas) have utilized internal limited partnerships to isolate liabilities and reduce franchise taxes. Because the Texas franchise/income tax prior to the effectiveness of the Margin Tax was based upon federal taxable income (computed on a separate company basis, for there has been no consolidation for Texas franchise tax purposes), the corporate partner was subject to franchise taxes to the extent that its distributive share of the partnership's income (whether or not distributed) was Texas-sourced.¹²⁸ If the limited partnership were structured such that the Texas parent was a 1% general partner and the 99% limited partner was incorporated in a state without an income tax (assume Nevada) and did not otherwise do business or pay franchise taxes in Texas (the ownership of a limited partner interest in a limited partnership doing business in Texas did not alone require the Nevada corporate limited partner to qualify in Texas as a foreign corporation or to pay Texas franchise taxes on its distributive share of the partnership's income), the income attributable to the 99% limited

¹²⁷ See Peggy Fikac, 'Income tax' is a loaded label for business levy - Perry opponents get fired up after accounting board calls it just that, *HoustonChronicle.com* -- <http://www.HoustonChronicle.com> | Section: Houston & Texas (August 10, 2006), <http://search.chron.com/chronicle/archiveSearch.do> (Type "Peggy Fikac" in the Author search box, then select date range of "August 10, 2006 to August 10, 2006"):

A board that sets national accounting standards stirred up the Texas governor's race by saying the state's new business tax is an income tax for reporting purposes. The decision by the Financial Accounting Standards Board embraced a label rejected by backers, including Republican Gov. Rick Perry, who championed the expanded business tax to lower local school property taxes. The designation gives fresh fodder to Perry challengers independent Carole Keeton Strayhorn, the state comptroller; independent Kinky Friedman; and Democrat Chris Bell. Strayhorn spokesman Mark Sanders said the ruling makes Perry the first governor in Texas history to sign into law an income tax. Bell spokesman Jason Stanford said Perry managed 'to pass not only the biggest tax increase in state history but also apparently a state income tax with the singular achievement of making sure that not one red cent will go to our public schools.' Friedman campaign director Dean Barkley added a call for litigation, saying, 'We urge the business people of Texas to take this issue to the courts and test its legality.' The Texas Constitution bars a tax on people's income without a statewide vote. Perry spokeswoman Kathy Walt and former state Comptroller John Sharp, a Democrat who headed the blue-ribbon panel that recommended the tax, dismissed the significance of the board's decision. 'It is merely an instruction to accountants on how to fill out a form,' said Walt, adding that Attorney General Greg Abbott 'has ruled that it's not an income tax. I'm going to take the attorney general's ruling, not the shrill tirade of the comptroller.' Abbott's top assistant, Barry McBee, Perry's former chief of staff, said in an April letter that the tax didn't conflict with the state constitution. Strayhorn was unsuccessful in seeking a formal opinion from Abbott."

¹²⁸ TEX. TAX CODE ANN. § 171.1032(c) (Vernon 2002 & Supp. 2004); Tex. S.B. 1125, 77th Leg., R.S. (2001).

partnership interest would not be subject to the Texas franchise/income tax. If the Nevada subsidiary subsequently dividended its income from the limited partnership to its Texas parent, then that dividend income would not be subjected to the Texas franchise/income tax because either the dividend was deducted in arriving at federal taxable income or it was a non-Texas receipt for franchise tax purposes. The foregoing is a simplification of a common internal limited partnership structure; the actual analysis, of course, was very fact specific and there were a number of structure variations available depending upon the objectives and the source of the income. Since the Margin Tax applies on a unitary and combined basis, the use of internal partnerships has become less effective as an alternative for reducing Texas entity level taxes.

7. Conversions. Though largely irrelevant for state tax purposes under the Margin Tax, transforming a corporate entity into a limited partnership structure previously was an expensive and time consuming procedure for reducing Texas franchise taxes because it required actual asset conveyances and liability assumptions, multiple entities (typically including a Delaware or Nevada entity that must avoid nexus with Texas), and consents of lenders, lessors and others. A simpler “conversion” method evolved utilizing the Check-the-Box Regulations and the conversion procedures in the TBCA, the TRLPA and the TRPA.¹²⁹ The conversion method required converting an existing corporate entity subject to Texas franchise tax to a Texas limited partnership or LLP. The converted entity then filed a Check-the-Box election to continue to be classified as a corporation for federal income tax purposes. For federal income tax purposes, the conversion should qualify as a nontaxable “F” reorganization. Thus, the entity ceased to be subject to Texas franchise tax when the conversion became effective, but continued to be treated as the same corporate entity for federal income tax purposes. The conversion method was suitable primarily for closely held corporations.

In Private Letter Ruling 2005 48021 (Dec. 2, 2005), the IRS found that an S corporation to LLC conversion did not create a second class of stock because the operating agreement for the LLC conferred identical rights on the members both as to distributions and liquidation.

Revenue Procedure 99-51, released by the IRS in December 1999 and reconfirmed by the IRS in Revenue Procedure 2013-3 issued in January 2013,¹³⁰ added an additional note of caution to the practice of using Texas’ conversion statutes to convert an existing corporation (with a valid S-corporation election but subject to Texas franchise taxes pre-conversion) into a limited partnership (with a Check-the Box election to be treated as a corporation for federal tax purposes but not subject to Texas franchise taxes post-conversion). The issue was whether the converted entity’s prior S-corporation election remains valid after its metamorphosis into a state law limited partnership due to the IRC’s requirement that an electing S-corporation may have only one class of stock. In at least one private letter ruling issued by the IRS prior to the publication of Revenue Procedure 99-51, the IRS sanctioned an S-corporation’s conversion under state law to a limited partnership and acquiesced in continued S-corporation election treatment where the taxpayer represented that general and limited partners had identical rights under the partnership agreement to distributions and liquidating proceeds.¹³¹ However, in Revenue Procedure 99-51

¹²⁹ See Appendix A Federal Taxation of Entities at B. Business Combinations Generally.

¹³⁰ Rev. Proc. 99-51, 1999-52 I.R.B. 761 (December 27, 1999) (superceded); Rev. Proc. 2013-3, 2013-1 I.R.B. 111 (January 3, 2013).

¹³¹ See, e.g., I.R.S. Priv. Ltr. Rul. 99-42-009 (October 25, 1999).

and Revenue Procedure 2013-3 the IRS stated that (i) the IRS will no longer rule on the single class of stock requirement in the limited partnership context until it studies the matter extensively and issues further published administrative guidance and (ii) the IRS will treat any request for an advance ruling on whether a state law limited partnership is eligible to elect S-corporation status as a request for a ruling on whether the entity has a single class of stock. Failure to continue a valid S-corporation election for a state law corporation converting to a state law limited partnership taxed as a corporation for federal tax purposes would be treated for tax purposes as a termination of the S election, which is effective as of the end of the day preceding the date of conversion. Until the IRS no-ruling policy is superseded, practitioners dealing with the conversion of existing S-corporations to partnerships in order to avoid Texas entity taxes may want to consider the alternative of using a subsidiary LLP (i.e., Checking-the-Box to be taxed as a corporation) in lieu of a limited partnership, and specifically drafting equal, pro rata treatment of the partners in the partnership agreement to overcome the single class of stock concern.

The applicability of the Margin Tax to limited partnerships removes conversions of corporations to limited partnerships as a means of reducing Texas entity taxes. Conversions to general partnerships, all of whose partners are individuals, remains a way to reduce Texas entity taxes, but this possible tax savings comes with the cost of personal liability.

APPENDIX C

CHOICE OF ENTITY DECISION MATRIX

A. KEY ELEMENTS. Key elements in deciding among business entities are:

1. How the entity will be taxed under federal and state law; and
2. Who will be liable for its contract, tort and statutory obligations (the entity itself will always be liable to the extent of its assets; the question is whether owners will be liable if entity's assets insufficient to satisfy all claims).

These two considerations tend to receive the principal focus in the entity choice decision, although management, capital raising, interest transferability, continuity of life and formation issues such as cost and timing can be critical in many cases.

If the owners are content to pay federal income taxes at the entity level at corporate rates of 15% to 35%, plus Margin Taxes, and then pay federal income taxes on earnings distributed to them, the choice is typically a "C corporation" (i.e., a regular business corporation without an S-corporation election)¹ or an LLC that elects to be taxed as a "C" corporation under the Check-the-Box Regulations.² Such an LLC may be preferable to a corporation in closely held situations because of greater governance structuring flexibility.³

If the owners do not want the entity's earnings to be taxed twice under the IRC, the entity selection process becomes more complicated,⁴ and the choices are:

- General partnership⁵
- LLP⁶
- Limited partnership⁷
- LLC⁸
- S-corporation⁹

(a) If limited liability of the owners is not important and all of them are individuals, the choice is a general partnership in which partners are jointly and severally liable for all partnership liabilities, as such a general partnership is not subject to the Margin Tax.¹⁰

¹ See Appendix A Federal Taxation of Entities ("Appendix A") at C.1 Taxation of C-Corporations.

² See Appendix A at C.1 Check the Box Regulations.

³ *Id.*

⁴ *Id.*

⁵ See Appendix A at A.2(b) Check-the-Box Regulations – The Default Rules and D.1 Taxation of General Partnerships – General Rule.

⁶ See Appendix A at A.2(b) Check-the-Box Regulations – The Default Rules and G. Taxation of LLPs.

⁷ See Appendix A at A.2(b) Check-the-Box Regulations – The Default Rules and E. Taxation of Limited Partnerships.

⁸ See Appendix A at A.2(b) Check-the-Box Regulations – The Default Rules and F. Taxation of LLC's

⁹ See Appendix A at C.2 Taxation of S-Corporations, C-3 Contributions of Appreciated Property and C.4 Self-Employment Tax.

(b) If the owners are willing to accept liability for their own torts but want to avoid liability for contracts and torts of other partners for which they have no culpability and are willing to risk being subject to the Margin Tax, the LLP becomes the entity of choice.¹¹

(c) The limited partnership will provide tax flow through without the S-corporation restrictions discussed below, with no self-employment tax on income of limited partners, and with limited liability for limited partners,¹² but has its own limitations:

1. Must have a general partner which is liable for all partnership obligations — contract and tort — but under Check-the-Box Regulations, capitalization of general partner is not important and a limited partnership can elect to also be an LLLP which has the effect of limiting the liability of the general partner;¹³
2. Limited partners who participate in the management of the business may become liable as general partners, but the limited partnership statutes generally allow a degree of participation without general partner personal liability unless the creditor relied upon the limited partner as a general partner;¹⁴ and
3. The Margin Tax is imposed on both limited partnerships and LLPs, although the LLP is a species of general partnership to which the Margin Tax generally is not applicable.¹⁵

(d) The LLC can be structured under the Check-the-Box Regulations to have tax flow through and the limited liability of S-corporation or limited partnership without any of their drawbacks, but:

- (i) The Margin Tax has replaced the Texas franchise tax and is imposed on LLCs;¹⁶
- (ii) Questions remain as to whether, or to what extent, individuals who are Members of an LLC will be subject to federal self-employment taxes;¹⁷ and
- (iii) Questions regarding:

¹⁰ See Appendix B Texas Margin Tax (“Appendix B”) at 3(a) Margin Tax – Who is Subject to Margin Tax.

¹¹ See Appendix A at A.2(b) Check-the-Box Regulations – The Default Rules and G. Taxation of LLPs; Appendix B at 3(a) Margin Tax – Who is Subject to Margin Tax; Chapter 6 – § 6.3A Liability Shielded After 2011 S.B. 748.

¹² See Chapter 4 – § 4.3 Owner Liability Issues; Appendix A at E.3 Taxation of Limited Partnerships – Self-Employment Tax.

¹³ *Id.*

¹⁴ See Chapter 4 – § 4.3 Owner Liability Issues.

¹⁵ See Appendix B at 3(a) Margin Tax – Who is Subject to Margin Tax.

¹⁶ *Id.*

¹⁷ See Appendix A at F.3 Taxation of LLCs – Self Employment Tax.

- State income taxation issues in other states; and
- The extent to which other states will recognize statutory limitation of Members' liability and the related questions of whether/how to qualify as a foreign LLC.¹⁸

(e) The S-corporation will give limitation of owner liability and federal income tax flow through (even when there is only one owner), but an S-corporation is subject to the Texas Margin Tax, and there are limitations on its availability under the IRC.¹⁹ S-corporation status is not available where the entity:

1. has more than 100 equity holders;
2. has more than one class of stock;
3. has among its shareholders any:
 - General or limited partnership;
 - Certain Trusts (most trusts are eligible if they make appropriate tax elections);
 - Non resident alien; or
 - Corporation.

B. TAX COSTS IN CHOICE OF ENTITY DECISION.

1. Assumptions in Following Chart. The following chart compares the taxes that would be paid by different types of entities and their individual owners based on assumed gross receipts, gross margin and net income in 2015. In each case, the entity is assumed to have (i) \$1,000 of gross revenue, (ii) \$700 of gross margin for Margin Tax purposes, which would be the maximum taxable margin under Tex. Tax Code § 171.101(a)(1) and all of which is apportioned to Texas under Tex. Tax Code § 171.101(a)(2), and (iii) \$100 of net income that is of a type subject to self-employment taxes (i.e., is income from a trade or business and is not investment income) and is distributed (after taxes) to its owners. It is also assumed that the individual owners will have earned income or wages in excess of the base amount for the tax year and will therefore be subject to only a 2.9% (3.8% on individual self employment income in excess of \$200,000 [\$250,000 in the case of a joint return; \$125,000 in the case of a married taxpayer filing separately]) Medicare tax on all self employment income (there is no ceiling), and not the 12.40% social security equivalent tax to a base of \$118,500 in 2015.

2. 3.8% Unearned Income Medicare Contribution Tax. The following chart does not consider the Unearned Income Medicare Contribution Tax to which individuals, estates and trusts are subject to for tax years beginning after December 31, 2012 on the lesser of net investment income for the tax year or the excess of modified adjusted gross income (“MAGI”) for the tax year over a threshold amount. Although the tax is an addition to regular federal income tax liability, it is taken into account for purposes of calculating estimated tax penalties of

¹⁸ See Chapter 7 – Extraterritorial Recognition of LLC and LLP Limited Liability.

¹⁹ See Appendix A at C.2 Taxation of S-Corporations.

the individual, estate or trust. The Unearned Income Medicare Contribution Tax in the case of an individual is 3.8% of the lesser of (1) the taxpayer's net investment income for the tax year or (2) the excess of MAGI for the tax year over the threshold amount of \$200,000 (\$250,000 in the case of joint filers and surviving spouses, and \$125,000 in the case of a married taxpayer filing separately). MAGI is the taxpayer's adjusted gross income increased by any foreign earned income excluded from gross income for the year, less any properly allocable deductions, exclusions or credits. Net investment income for purposes of the Unearned Income Medicare Contribution Tax is the sum of the following items (less any otherwise allowable deductions properly allocable thereto): (i) gross income from interest, dividends, annuities, royalties and rents other than such income derived in the ordinary course of a trade or business other than a passive trade or business; (ii) other gross income from a passive trade or business; and (iii) net gain which is included in computing taxable income of the taxpayer that is attributable to the disposition of property unless such property is held in a trade or business other than a passive trade or business. A passive trade or business for this purpose includes any trade or business of the taxpayer that is either a passive activity or consists of trading financial instruments or commodities. In the case of the disposition of an interest in a partnership or S-corporation, net gain or loss is considered net investment income only to the extent it would be taken into account by the partner or shareholder if all of the property of the partnership or S-corporation were sold at fair market value immediately before the disposition of the interest. Net investment income does not include any distribution from qualified employee benefit plans or arrangements. The Unearned Income Medicare Contribution Tax is not deductible in computing other federal income taxes. On November 26, 2013, Treasury issued final regulations and new proposed regulations regarding the Unearned Income Medicare Contribution Tax. Notably, the final regulations withdrew the method for calculating net gain or loss upon the disposition of an interest in a partnership or S-corporation. The method described in the prior proposed regulations would have required transferors to obtain fair market value information from partnerships and S-corporations in order to determine the portion of the gain which was included in net investment income. Many commentators viewed the method as overly burdensome, and in response, Treasury provided a new method of calculating net gain or loss as well as an optional simplified method.

3. Relative Tax Costs of Entities Chart.

Item	C-Corporation	S-Corp or Limited Liability Company ^(b)	General Partner in LLP or Limited Partnership ^(b)	Limited Partner in Limited Partnership ^(b)
Entity Level				
Total Revenue	1,000.00	1,000.00	1,000.00	1,000.00
Taxable Margin	700.00	700.00	700.00	700.00
Net Income	100.00	100.00	100.00	100.00
Margin Tax ^(c)	6.65	6.65	6.65	6.65
Taxable Income of Entity	93.35	93.35	93.35	93.35
Fed. Income Tax (at 35%)	32.67	0	0	0
Income After Taxes ^(d)	60.68	93.35	93.35	93.35
Owner Level				
Distribution & Share of Income	60.68	93.35	93.35	93.35
Self-Employment Tax	0	2.90 ^(e)	2.90 ^(e)	0
Taxable Income of Owner	60.68	91.90 ^(f)	91.90 ^(f)	93.35
Fed. Tax on Dividends (20%) or Income Allocation (39.6%)	12.14	36.39	36.39	36.97
Amount Received After Personal Income Taxes	48.54	55.51	55.51	56.38

- (a) Individuals are subject to a self-employment tax on self-employment income. For 2015 the tax rate aggregates up to 15.3% and consists of (i) a 12.40% social security equivalent tax on self-employment income up to a 2015 contribution base of \$118,500 (adjusted annually for inflation), plus (ii) a 2.9% (3.8% on individual self-employment income in excess of \$200,000 [\$250,000 in the case of a joint return; \$125,000 in the case of a married taxpayer filing separately]) tax for hospital insurance (“Medicare”) on all self-employment income (there is no ceiling). This self-employment tax is treated as part of the income tax and must also be taken into account for purposes of the estimated tax. A similar addition to Medicare tax applies for FICA purposes. If the taxpayer has wages subject to FICA, then the taxpayer’s social security equivalent wage base would be reduced by amount of wages on which these taxes were paid. There is no cap on self-employment income subject to the Medicare tax.
- (b) Assumes that the entity is treated as a partnership for federal income tax purposes. A general partnership which has not qualified as an LLP would not be subject to the Margin Tax.
- (c) Assumes that (i) Margin Tax is applicable since gross receipts are all in 2015, (ii) the gross margin for Margin Tax purposes is \$700, which would be the maximum taxable margin under Tex. Tax Code § 171.101(a)(1), and all of it is apportioned to Texas under Tex. Tax Code § 171.101(a)(2), and (iii) the applicable Margin Tax rate is the 0.95% (the rate is 0.475% for a narrowly defined group of retail and wholesale businesses) applicable for 2015; effective for tax reports due after January 1, 2016, these rates are reduced to 0.75% and 0.375% by S.B. 32 passed in the 2015 Legislative Session. Under Tex. Tax Code § 171.101(a)(1) a taxable entity’s taxable margin is the lesser of (x) 70% of its total revenue or (y) an amount determined by subtracting from its total revenue either its cost of goods sold or its compensation paid as elected or deemed elected pursuant to the Tex. Tax Code. See Appendix B. Assumes the business cannot take advantage of the \$1 million alternative minimum deduction effective for the 2015 report. Tex. Tax Code § 171.002.
- (d) The income after taxes of most entities is the net income of the entity less the Margin Tax and, in the case of the C-corporation, the applicable federal income taxes.
- (e) A non-managing member of an LLC may not be subject to the self-employment tax; a shareholder of an S-corporation is not subject to self-employment tax on his share of its income but would be subject to employment tax on compensation received.
- (f) Only one-half of the self-employment tax is deductible against the individual’s income for federal income tax purposes.
- (g) Does not take into account the 3.8% Unearned Income Medicare Contribution Tax on net investment income discussed above under B.2 – 3.8% Unearned Income Medicare Contribution Tax.

C. ENTITY COMPARISON CHART.

Item	Sole Proprietorship	General Partnership	Limited Liability Partnership	Limited Partnership	Limited Liability Company	“C” Corp.	“S” Corp.
Limited liability of owners for entity obligations	No	No	Yes	Yes	Yes	Yes	Yes
Name	No requirements	No requirements	L.L.P. must contain “limited liability partnership” or an abbreviation thereof.	Must contain “limited partnership,” “limited,” or an abbreviation of either.	Must contain “limited liability company,” “limited company,” or an abbreviation of either (unless formed prior to September 1, 1993 in compliance with the laws then in effect).	Must contain “corporation,” “company,” “incorporated,” “limited,” or an abbreviation of any of these.	Must contain “corporation,” “company,” “incorporated,” “limited,” or an abbreviation of any of these.
Filing Requirements	Assumed name certificate filing and payment of applicable filing fees	Assumed name certificate filing and payment of applicable filing fees	Annual registration and filing fee of \$200 per partner; must maintain liability insurance or meet alternative financial responsibility test	Certificate of formation and filing fee of \$750	Certificate of formation and filing fee of \$300	Certificate of formation and filing fee of \$300	Certificate of formation and filing fee of \$300
Ownership Types	Individuals	Any	Any	Any	Any	Any	Limited
No. of Owners	One	Minimum of 2	Minimum of 2	Minimum of 2	Single member LLCs permitted in texas	No restrictions	No more than 100

Item	Sole Proprietorship	General Partnership	Limited Liability Partnership	Limited Partnership	Limited Liability Company	“C” Corp.	“S” Corp.
Professionals	Yes	Yes	Yes	Yes	Yes	Yes, but generally governed by TBOC Title 7 Professional Entities if there is conflict with TBOC Title 2 Corporations. For entities existing prior to January 1, 2006, generally governed by Texas Professional Corporation Act or Texas Professional Association Act	Yes, but generally governed by TBOC Title 7 Professional Entities if there is conflict with TBOC Title 2 Corporations. For entities existing prior to January 1, 2006, generally governed by Texas Professional Corporation Act or Texas Professional Association Act
Ownership Classes	One	Multiple classes allowed	Multiple classes allowed	Multiple classes allowed but must have at least 1 general partner and 1 limited partner.	Multiple classes allowed	Multiple classes allowed	Limitation as to 1 class of stock
Transferability of Interests	Freely transferable	Economic interest is transferable unless restricted by partnership agreement; however, the status of partner is not transferable without consent of all partners	Economic interest is transferable unless restricted by partnership agreement; however, the status of partner is not transferable without consent of all partners	Economic interest is transferable unless restricted by partnership agreement; however, the status of partner is not transferable without consent of all partners	Economic membership interest freely transferable unless restricted by articles of organization or regulations; however, unless otherwise provided in articles of organization or regulations, the status of member is not transferable without consent of all members	Freely transferable unless restricted by articles of incorporation, bylaws or shareholder agreement	Freely transferable unless restricted by articles of incorporation, bylaws or shareholder agreement

**D. BASIC TEXAS BUSINESS ENTITIES AND FEDERAL/STATE TAXATION
ALTERNATIVES CHART**

<i>Texas Law Entity</i>	<i>Check-the-Box</i>	<i>Federal Taxation</i>	<i>TX Franchise Tax until 1/1/16²⁰</i>	<i>TX Margin Tax 1/1/16</i>
Proprietorship	Not Applicable	Form 1040, Schedule C or E	None	None
LLC / single individual member	Disregarded²¹	Form 1040, Schedule C or E (Proprietorship)	Yes	Yes
LLC / single entity member	Disregarded²	Division of Member Entity	Yes	Yes
General Partnership or LLP	Partnership²²	Partnership	None	Depends
General Partnership or LLP	Corporation	C or S-Corp²³	None	Depends
Limited Partnership	Partnership³	Partnership	None	Yes
Limited Partnership	Corporation	C or S-Corp⁴	None	Yes²⁴
LLC / multi-members	Partnership³	Partnership	Yes	Yes
LLC / multi-members	Corporation	C or S-Corp⁴	Yes	Yes
Corporation	Not Applicable	C or S-Corp⁴	Yes	Yes

²⁰ Effective January 1, 2007, the Margin Tax replaced the Texas franchise tax and is applicable to all partnerships (other than general partnerships composed entirely of individuals). See Appendix B at 3(a) Margin Tax – Who is Subject to Margin Tax.

²¹ Unless a single member LLC affirmatively makes an election on IRS Form 8832 to be taxed as a corporation, it defaults to being disregarded for federal tax purposes. Treas. Reg. § 301.7701-3(b)(ii). Thus, where the single member of the LLC is an individual, the result is that the LLC is treated as a proprietorship for federal income tax purposes; where the single member of the LLC is an entity, the result is that the LLC is treated as if it were a division of the owning entity for federal income tax purposes.

²² Unless a partnership or multi-member LLC affirmatively makes an election on IRS Form 8832 to be taxed as a corporation, it defaults to being taxed as a partnership for federal tax purposes. Treas. Reg. § 301.7701-3(b)(i).

²³ To be taxed as an S Corp, the entity and all of its equity owners must make a timely election on Form 2553 and meet several other requirements, generally having only citizen/resident individuals or estates as equity owners (with the exception of certain qualifying trusts and other holders), no more than 100 owners, and only one “class of stock.” IRC § 1361(b).

²⁴ Unless LP qualifies as a “passive” entity. TEX. TAX CODE § 171.0003. See Appendix B at 3(a) Margin Tax – Who is Subject to Margin Tax.

**EFFECT OF SARBANES-OXLEY ACT OF 2002
ON COMMON LAW FIDUCIARY DUTIES.**

I. OVERVIEW

Responding to problems in corporate governance, SOX and related changes to SEC rules and stock exchange listing requirements¹ have implemented a series of reforms that require all public companies² to implement or refrain from specified actions,³ some of which are expressly permitted by state corporate laws, subject to general fiduciary principles. Several examples of this interaction of state law with SOX or new SEC or stock exchange requirements are discussed below.

¹ On November 4, 2003, the SEC issued Exchange Act Release No. 48,745, titled “Self-Regulatory Organizations; New York Stock Exchange, Inc. and National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Changes,” pursuant to which the SEC approved the rule changes proposed by the NYSE and NASD to comply with SOX. Self-Regulatory Organizations; New York Stock Exchange, Inc. and National Association of Securities Dealers, Inc.; Order Approving Proposed Rule Changes, Exchange Act Release No. 48,745, 81 S.E.C. Docket 1586 (Nov. 4, 2003), *available at* <http://www.sec.gov/rules/sro/34-48745.htm>. These rule changes are now effective for all NYSE and NASDAQ listed companies. Any references to the rules in the NYSE Listed Company Manual (the “NYSE Rules”) or the marketplace rules in the NASD Manual (the “NASD Rules”) are references to the rules as approved by the SEC in or after 2003.

² SOX is generally applicable to all companies required to file reports with the SEC under the 1934 Act (“reporting companies”) or that have a registration statement on file with the SEC under the 1933 Act, in each case regardless of size (collectively, “public companies” or “issuers”). Some of the SOX provisions apply only to companies listed on a national securities exchange (“listed companies”), such as the New York Stock Exchange (“NYSE”), the American Stock Exchange (“AMEX”) or the NASDAQ Stock Market (“NASDAQ”) (the national securities exchanges and NASDAQ are referred to collectively as “SROs”), but not to companies traded on the NASD OTC Bulletin Board or quoted in the Pink Sheets or the Yellow Sheets. SOX and the SEC’s rules thereunder are applicable in many, but not all, respects to (i) investment companies registered under the Investment Company Act of 1940 (the “1940 Act”) and (ii) public companies domiciled outside of the United States (“foreign companies”), although many of the SEC rules promulgated under SOX’s directives provide limited relief from some SOX provisions for the “foreign private issuer,” which is defined in 1933 Act Rule 405 and 1934 Act Rule 3b-4(c) as a private corporation or other organization incorporated outside of the U.S., as long as:

- More than 50% of the issuer’s outstanding voting securities are not directly or indirectly held of record by U.S. residents;
- The majority of the executive officers or directors are not U.S. citizens or residents;
- More than 50% of the issuer’s assets are not located in the U.S.; and;
- The issuer’s business is not administered principally in the U.S.

³ See Byron F. Egan, *The Sarbanes-Oxley Act and Its Expanding Reach*, 40 TEX. J. BUS. L. 305 (Winter 2005), *available at* <http://www.jw.com/site/jsp/publicationinfo.jsp?id=505>; Byron F. Egan, *Communicating with Auditors After the Sarbanes-Oxley Act*, 41 TEX. J. BUS. L. 131 (Fall 2005); Byron F. Egan, *Perils of In-House Counsel* (July 22, 2010), <http://www.jw.com/site/jsp/publicationinfo.jsp?id=1430>.

II. SHAREHOLDER CAUSES OF ACTION

SOX does not create new causes of action for shareholders, with certain limited exceptions, and leaves enforcement of its proscriptions to the SEC or federal criminal authorities.⁴ The corporate plaintiffs' bar, however, can be expected to be creative and aggressive in asserting that the new standards of corporate governance should be carried over into state law fiduciary duties, perhaps by asserting that violations of SOX constitute violations of fiduciary duties of obedience or supervision.⁵

III. DIRECTOR INDEPENDENCE

A. Power to Independent Directors.

1. General. The SEC rules under SOX and related stock exchange listing requirements are shifting the power to govern public companies to outside directors. Collectively, they will generally require that listed companies have:

- A board of directors, a majority of whom are independent;⁶
- An audit committee⁷ composed entirely of independent directors;⁸

⁴ “Except in the case of recovery of profits from prohibited sales during a blackout period and suits by whistleblowers, the Sarbanes-Oxley Act does not expressly create new private rights of action for civil liability for violations of the Act. The Sarbanes-Oxley Act, however, potentially affects existing private rights of action under the Exchange Act by: (1) lengthening the general statute of limitations applicable to private securities fraud actions to the earlier of two years after discovery of the facts constituting the violation or five years after the violation; and (2) expanding reporting and disclosure requirements that could potentially expand the range of actions that can be alleged to give rise to private suits under Section 10(b) and Section 18 of the Exchange Act and SEC Rule 10b-5.” Patricia A. Vlahakis et al., *Understanding the Sarbanes-Oxley Act of 2002*, CORP. GOVERNANCE REFORM, Sept.-Oct. 2002, at 16.

⁵ See William B. Chandler III & Leo E. Strine Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State* (February 26, 2002), at 43–48 (NYU Ctr. for Law and Bus. Research Paper Working Paper Series, Paper No. 03-01; U. of Penn. Inst. for Law & Econ. Working Paper Series, Research Paper No. 03-03) (Posted Jan. 8, 2003, *last revised* Mar. 13, 2003), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=367720.

⁶ See NYSE Rules 303A.01, 303A.02; NASD Rules 4350(c)(1), 4200(a)(15).

⁷ The 1934 Act § 3(a)(58) added by SOX § 2(a)(3) provides:

(58) *Audit Committee.* The term “audit committee” means –

- (A) A committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer; and
- (B) If no such committee exists with respect to an issuer, the entire board of directors of the issuer.

⁸ On April 9, 2003, the SEC issued Release No. 33-8220 (the “*SOX § 301 Release*”) adopting, effective April 25, 2003, 1934 Act Rule 10A-3, titled “Standards Relating to Listed Company Audit Committees” (the “*SOX § 301 Rule*”), to implement SOX § 301. Standards Relating to Listed Company Audit, Securities Act Release No. 8220, Exchange Act Release No. 47,654, Investment Company Act Release No. 26,001, 79 S.E.C. Docket 2876 (Apr. 9 2003), available at <http://www.sec.gov/rules/final/33-8220.htm>.

- A nominating/corporate governance committee composed entirely of independent directors;⁹ and
- A compensation committee composed entirely of independent directors.¹⁰

Under the SOX § 301 Rule, each SRO must adopt rules conditioning the listing of any securities of an issuer upon the issuer being in compliance with the standards specified in SOX § 301, which may be summarized as follows:

- Oversight. The audit committee must have direct responsibility for the appointment, compensation, and oversight of the work (including the resolution of disagreements between management and the auditors regarding financial reporting) of any registered public accounting firm employed to perform audit services, and the auditors must report directly to the audit committee.
- Independence. The audit committee members must be independent directors, which means that each member may not, other than as compensation for service on the board of directors or any of its committees: (i) accept any consulting, advisory or other compensation, directly or indirectly, from the issuer or (ii) be an officer or other affiliate of the issuer.
- Procedures to Receive Complaints. The audit committee is responsible for establishing procedures for the receipt, retention and treatment of complaints regarding accounting, internal accounting controls or auditing matters, and the confidential, anonymous submission by employees of the issuer (“whistleblowers”) of concerns regarding questionable accounting or auditing matters.
- Funding and Authority. The audit committee must have the authority to hire independent counsel and other advisers to carry out its duties, and the issuer must provide for funding, as the audit committee may determine, for payment of compensation of the issuer’s auditor and of any advisers that the audit committee engages.

SROs may adopt additional listing standards regarding audit committees as long as they are consistent with SOX and the SOX § 301 Rule. The NYSE and NASD have adopted such rules, which are discussed below. See NYSE Rules 303A.06, 303A.07; NASD Rule 4350(d).

⁹ See NYSE Rule 303A.04; NASD Rule 4350(c)(4).

¹⁰ See NYSE Rule 303A.05; NASD Rule 4350(c)(3). The compensation committee typically is composed of independent directors and focuses on executive compensation and administration of stock options and other incentive plans. While the duties of the compensation committee will vary from company to company, the *ALI’s Principles of Corporate Governance* § 3A.05 (Supp 2002) recommend that the compensation committee should:

- (1) Review and recommend to the board, or determine, the annual salary, bonus, stock options, and other benefits, direct and indirect, of the senior executives.
- (2) Review new executive compensation programs; review on a periodic basis the operation of the corporation’s executive compensation programs to determine whether they are properly coordinated; establish and periodically review policies for the administration of executive compensation programs; and take steps to modify any executive compensation programs that yield payments and benefits that are not reasonably related to executive performance.
- (3) Establish and periodically review policies in the area of management perquisites.

Under SEC Rule 16b-3 under the 1934 Act, the grant and exercise of employee stock options, and the making of stock awards, are generally exempt from the short-swing profit recovery provisions of § 16(b) under the 1934 Act if approved by a committee of independent directors. Further, under Section 162(m) of the Internal Revenue Code of 1980, as amended, corporations required to be registered under the 1934 Act are not able to deduct compensation to specified individuals in excess of \$1,000,000 per year, except in the case of performance based compensation arrangements approved by

These independent directors will be expected to actively participate in the specified activities of the board of directors and the committees on which they serve.

State law authorizes boards of directors to delegate authority to committees of directors. Texas and Delaware law both provide that boards of directors may delegate authority to committees of the Board subject to limitations on delegation for fundamental corporate transactions.¹¹ Among the matters that a Board committee will not have the authority to approve are (i) charter amendments, except to the extent such amendments are the result of the issuance of a series of stock permitted to be approved by a Board, (ii) a plan of merger or similar transaction, (iii) the sale of all or substantially all of the assets of the corporation outside the ordinary course of its business, (iv) a voluntary dissolution of the corporation and (v) amending bylaws or creating new bylaws of the corporation.¹² In addition, under Texas law, a Board committee may not fill any vacancy on the Board, remove any officer, fix the compensation of a member of the committee or amend or repeal a resolution approved by the whole Board to the extent that such resolution by its terms is not so amendable or repealable.¹³ Further, under both Texas and Delaware law, no Board committee has the authority to authorize a distribution (a dividend in the case of Delaware law) or authorize the issuance of stock of a corporation unless that authority is set forth in the charter or bylaws of the corporation.¹⁴ Alternative members may also be appointed to committees under both states' laws.¹⁵

2. NYSE. NYSE Rule 303A.01 requires the Board of each NYSE listed company to consist of a majority of independent directors.

(a) NYSE Base Line Test. Pursuant to NYSE Rule 303A.02, no director qualifies as "independent" unless the board affirmatively determines that the director has no material relationship with the company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company). The company is required to disclose the basis for such determination in its annual proxy statement or, if the company does not file an annual proxy statement, in the company's annual report on Form 10-K filed with the SEC. In complying with this requirement, the company's Board is permitted to adopt and disclose standards to assist it in making determinations of independence, disclose those standards, and then make the general statement that the independent directors meet those standards.

the shareholders and administered by a compensation committee consisting of two or more "outside directors" as defined. Treas. Reg. § 1.162-27 (2002).

¹¹ TBOC § 21.416; TBCA art. 2.36; DGCL § 141(c). These restrictions only apply to Delaware corporations that incorporated prior to July 1, 1996, and did not elect by board resolution to be governed by DGCL § 141(c)(2). If a Delaware corporation is incorporated after that date or elects to be governed by DGCL § 141(c)(2), then it may authorize a board committee to declare dividends or authorize the issuance of stock of the corporation.

¹² TBOC § 21.416; TBCA art. 2.36; DGCL § 141(c).

¹³ TBOC § 21.416; TBCA art. 2.36(B).

¹⁴ TBOC § 21.416(d); TBCA art. 2.36(C); DGCL § 141(c)(1). In Texas, such authorization may alternatively appear in the resolution designating the committee. TBOC § 21.416(d); TBCA art. 2.36(C).

¹⁵ TBOC § 21.416(a); TBCA art. 2.36(A); DGCL § 141(c)(1).

(b) NYSE Per Se Independence Disqualifications. In addition to the general requirement discussed above, NYSE Rule 303A.02 considers a number of relationships to be an absolute bar on a director being independent as follows:

First, a director who is an employee, or whose immediate family member is an executive officer, of the company would not be independent until three years after the end of such employment (employment as an interim Chairman or CEO will not disqualify a director from being considered independent following that employment).

Second, a director who has received, or whose immediate family member has received, more than \$120,000 in any twelve-month period within the last three years in direct compensation from the NYSE listed company, except for certain payments, would not be independent.

Third, a director who is, or who has an immediate family member who is, a current partner of a firm that is the NYSE listed company's internal or external auditor; a director who is a current employee of such a firm; a director who has an immediate family member who is a current employee of such a firm and who participates in the firm's audit, assurance or tax compliance (but not tax planning) practice; or a director who was, or who has an immediate family member who was, within the last three years (but is no longer) a partner or employee of such a firm and personally worked on the NYSE listed company's audit within that time.

Fourth, a director who is employed, or whose immediate family member is employed, as an executive officer of another company where any of the NYSE listed company's present executives served on that company's compensation committee at the same time can not be considered independent until three years after the end of such service or the employment relationship.

Fifth, a director who is a current employee, or whose immediate family member is a current executive officer, of a company that has made payments to, or received payments from, the NYSE listed company for property or services in an amount which, in any of the last three fiscal years, exceeds the greater of \$1 million, or 2% of such other company's consolidated gross revenues. Charitable organizations are not considered "companies" for purposes of the exclusion from independence described in the previous sentence, provided that the NYSE listed company discloses in its annual proxy statement, or if the NYSE listed company does not file an annual proxy statement, in its annual report on Form 10-K filed with the SEC, any charitable contributions made by the NYSE listed company to any charitable organization in which a director serves as an executive officer if, within the preceding three years, such contributions in any single year exceeded the greater of \$1 million or 2% of the organization's consolidated gross revenues.

3. NASDAQ. NASD Rule 4350(c)(1) requires a majority of the directors of a NASDAQ-listed company to be “*independent directors*,” as defined in NASD Rule 4200.¹⁶

(a) NASDAQ Base Line Test. NASD Rule 4350(c)(1) requires each NASDAQ listed company to disclose in its annual proxy (or, if the issuer does not file a proxy, in its Form 10-K or 20-F) those directors that the Board has determined to be independent as defined in NASD Rule 4200.¹⁷

(b) NASDAQ Per Se Independence Disqualifications. NASD Rule 4200(a)(15) specifies certain relationships that would preclude a board finding of independence as follows:

First, a director who is, or at anytime during the past three years was, employed by the NASDAQ listed company or by any parent or subsidiary of the company (the “*NASDAQ Employee Provision*”).

Second, a director who accepted or has a family member who accepted any payments from the NASDAQ listed company, or any parent or subsidiary of the company, in excess of \$60,000 during any period of twelve consecutive months within the three years preceding the determination of independence other than certain permitted payments (the “*NASDAQ Payments Provision*”). NASDAQ states in the interpretive material to the NASD Rules (the “*NASDAQ Interpretive Material*”) that this provision is generally intended to capture situations where a payment is made directly to, or for the benefit of, the director or a family member of the director. For example, consulting or personal service contracts with a director or family member of the director or political contributions to the campaign of a director or a family member of the director prohibit independence.

Third, a director who is a family member of an individual who is, or at any time during the past three years was, employed by the company or by any parent or subsidiary of the company as an executive officer (the “*NASDAQ Family of Executive Officer Provision*”).

Fourth, a director who is, or has a family member who is, a partner in, or a controlling shareholder or an executive officer of, any organization to which the company made, or from which the company received, payments for property or services in the current or any of the past three fiscal years that exceed 5% of the recipient’s consolidated gross revenues for that year, or \$200,000, whichever is more, other than certain permitted payments (the “*NASDAQ Business*”).

¹⁶ NASD Rule 4350, which governs qualitative listing requirements for NASDAQ National Market and NASDAQ SmallCap Market issuers (other than limited partnerships), must be read in tandem with NASD Rule 4200, which provides definitions for the applicable defined terms.

¹⁷ If a NASDAQ listed company fails to comply with the requirement that a majority of its board of directors be independent due to one vacancy, or one director ceases to be independent due to circumstances beyond a company’s reasonable control, NASD Rule 4350(c)(1) requires the issuer to regain compliance with the requirement by the earlier of its next annual shareholders meeting or one year from the occurrence of the event that caused the compliance failure. Any issuer relying on this provision must provide notice to NASDAQ immediately upon learning of the event or circumstance that caused the non-compliance.

Relationship Provision”). The NASDAQ Interpretive Material states that this provision is generally intended to capture payments to an entity with which the director or family member of the director is affiliated by serving as a partner (other than a limited partner), controlling shareholder or executive officer of such entity. Under exceptional circumstances, such as where a director has direct, significant business holdings, the NASDAQ Interpretive Material states that it may be appropriate to apply the NASDAQ Business Relationship Provision in lieu of the NASDAQ Payments Provision described above, and that issuers should contact NASDAQ if they wish to apply the rule in this manner. The NASDAQ Interpretive Material further notes that the NASDAQ Business Relationship Provision is broader than the rules for audit committee member independence set forth in 1934 Act Rule 10A-3(e)(8).

The NASDAQ Interpretive Material further states that under the NASDAQ Business Relationship Provision, a director who is, or who has a family member who is, an executive officer of a charitable organization may not be considered independent if the company makes payment to the charity in excess of the greater of 5% of the charity’s revenues or \$200,000. The NASDAQ Interpretive Material also discusses the treatment of payments from the issuer to a law firm in determining whether a director who is a lawyer may be considered independent. The NASDAQ Interpretive Material notes that any partner in a law firm that receives payments from the issuer is ineligible to serve on that issuer’s audit committee.

Fifth, a director who is, or has a family member who is, employed as an executive officer of another entity where at any time during the past three years any of the executive officers of the NASDAQ listed company serves on the compensation committee of such other entity (“NASDAQ Interlocking Directorate Provision”).

Sixth, a director who is, or has a family member who is, a current partner of the company’s outside auditor, or was a partner or employee of the company’s outside auditor, and worked on the company’s audit, at any time, during the past three years (“NASDAQ Auditor Relationship Provision”).

Seventh, in the case of an investment company, a director who is an “interested person” of the company as defined in section 2(a)(19) of the Investment Company Act, other than in his or her capacity as a member of the Board or any Board committee.

With respect to the look-back periods referenced in the NASDAQ Employee Provision, the NASDAQ Family of Executive Officer Provision, the NASDAQ Interlocking Directorate Provision, and the NASDAQ Auditor Relationship Provision, “any time” during any of the past three years should be considered. The NASDAQ Interpretive Material states that these three year look-back periods commence on the date the relationship ceases. As an example, the NASDAQ Interpretive Material states that a director employed by the NASDAQ listed company would not be independent until three years after such employment terminates. The NASDAQ Interpretive Material states that the reference to a “parent or subsidiary” in the definition of

independence is intended to cover entities the issuer controls and consolidates with the issuer's financial statements as filed with the SEC (but not if the issuer reflects such entity solely as an investment in its financial statements). The NASDAQ Interpretive Material also states that the reference to "executive officer" has the same meaning as the definition in Rule 16a-1(f) under the 1934 Act.

B. Audit Committee Member Independence.

1. SOX. To be "independent" and thus eligible to serve on an issuer's audit committee under the SOX § 301 Rule, (i) audit committee members may not, directly or indirectly, accept any consulting, advisory or other compensatory fee from the issuer or a subsidiary of the issuer, other than in the member's capacity as a member of the Board and any Board committee (this prohibition would preclude payments to a member as an officer or employee, as well as other compensatory payments; indirect acceptance of compensatory payments includes payments to spouses, minor children or stepchildren or children or stepchildren sharing a home with the member, as well as payments accepted by an entity in which an audit committee member is a general partner, managing member, executive officer or occupies a similar position and which provides accounting, consulting, legal, investment banking, financial or other advisory services or any similar services to the issuer or any subsidiary; receipt of fixed retirement plan or deferred compensation is not prohibited)¹⁸ and (ii) a member of the audit committee of an issuer may not be an "affiliated person" of the issuer or any subsidiary of the issuer apart from his or her capacity as a member of the Board and any board committee (subject to the safe harbor described below).¹⁹

Since it is difficult to determine whether someone controls the issuer, the SOX § 301 Rule creates a safe harbor regarding whether someone is an "affiliated person" for purposes of meeting the audit committee independence requirement. Under the safe harbor, a person who is not an executive officer, director or 10% shareholder of the issuer would be deemed not to control the issuer. A person who is ineligible to rely on the safe harbor, but believes that he or she does not control an issuer, still could rely on a facts and circumstances analysis. This test is similar to the test used for determining insider status under 1934 Act § 16.

The SEC has authority to exempt from the independence requirements particular relationships with respect to audit committee members, if appropriate in light of the circumstances. Because companies coming to market for the first time may face particular difficulty in recruiting members that meet the proposed independence requirements, the SOX § 301 Rule provides an exception for non-investment company issuers that requires only one fully independent member at the time of the effectiveness of an issuer's initial registration

¹⁸ The SOX § 301 Rule restricts only current relationships and does not extend to a "look back" period before appointment to the audit committee, although SRO rules may do so.

¹⁹ The terms "affiliate" and "affiliated person" are defined consistent with other definitions of those terms under the securities laws, such as in 1934 Act Rule 12b-2 and 1933 Act Rule 144, with an additional safe harbor. In the SOX § 301 Release, the SEC clarified that an executive officer, general partner and managing member of an affiliate would be deemed to be an affiliate, but outside directors, limited partners and others with no policy making function would not be deemed affiliates. Similarly, a member of the audit committee of an issuer that is an investment company could not be an "interested person" of the investment company as defined in 1940 Act § 2(a)(19).

statement under the 1933 Act or the 1934 Act, a majority of independent members within 90 days and a fully independent audit committee within one year.

For companies that operate through subsidiaries, the composition of the Boards of the parent company and subsidiaries are sometimes similar given the control structure between the parent and the subsidiaries. If an audit committee member of the parent is otherwise independent, merely serving on the Board of a controlled subsidiary should not adversely affect the Board member's independence, assuming that the board member also would be considered independent of the subsidiary except for the member's seat on the parent's Board. Therefore, SOX § 301 Rule exempts from the "affiliated person" requirement a committee member that sits on the Board of both a parent and a direct or indirect subsidiary or other affiliate, if the committee member otherwise meets the independence requirements for both the parent and the subsidiary or affiliate, including the receipt of only ordinary-course compensation for serving as a member of the Board, audit committee or any other Board committee of the parent, subsidiary or affiliate. Any issuer taking advantage of any of the exceptions described above would have to disclose that fact.

2. NYSE.

(a) Audit Committee Composition. NYSE Rules 303A.06 and 303A.07 require each NYSE listed company to have, at a minimum, a three person audit committee composed entirely of directors that meet the independence standards of both NYSE Rule 303A.02 and 1934 Act Rule 10A-3. The Commentary to NYSE Rule 303A.06 states: "The [NYSE] will apply the requirements of SEC Rule 10A-3 in a manner consistent with the guidance provided by the Securities and Exchange Commission in SEC Release No. 34-47654 (April 1, 2003). Without limiting the generality of the foregoing, the [NYSE] will provide companies with the opportunity to cure defects provided in SEC Rule 10A-3(a)(3)."

The Commentary to NYSE Rule 303A.07 requires that each member of the audit committee be financially literate, as such qualification is interpreted by the board in its business judgment, or become financially literate within a reasonable period of time after his or her appointment to the audit committee. In addition, at least one member of the audit committee must have accounting or related financial management expertise, as the NYSE listed company's board interprets such qualification in its business judgment. While the NYSE does not require an NYSE listed company's audit committee to include a person who satisfies the definition of audit committee financial expert set forth in Item 401(h) of Regulation S-K, a board may presume that such a person has accounting or related financial management experience.

If an audit committee member simultaneously serves on the audit committee of more than three public companies, and the NYSE listed company does not limit the number of audit committees on which its audit committee members serve to three or less, each board is required to determine that such simultaneous service does not impair the ability of such board member to effectively serve on the NYSE listed company's audit committee and to disclose such determination.

(b) Audit Committee Charter and Responsibilities. NYSE Rule 303A.07(c) requires the audit committee of each NYSE listed company to have a written audit committee charter that

addresses: (i) the committee’s purpose; (ii) an annual performance evaluation of the audit committee; and (iii) the duties and responsibilities of the audit committee (“NYSE Audit Committee Charter Provision”).

The NYSE Audit Committee Charter Provision provides details as to the duties and responsibilities of the audit committee that must be addressed. These include, at a minimum, those set out in 1934 Act Rule 10A-3(b)(2), (3), (4) and (5), as well as the responsibility to at least annually obtain and review a report by the independent auditor; meet to review and discuss the company’s annual audited financial statements and quarterly financial statements with management and the independent auditor, including reviewing the NYSE listed company’s specific disclosures under MD&A; discuss the company’s earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies; discuss policies with respect to risk assessment and risk management; meet separately, periodically, with management, with internal auditors (or other personnel responsible for the internal audit function), and with independent auditors; review with the independent auditors any audit problems or difficulties and management’s response; set clear hiring policies for employees or former employees of the independent auditors; and report regularly to the board. The commentary to NYSE Rule 303A.07 explicitly states that the audit committee functions specified in NYSE Rule 303A.07 are the sole responsibility of the audit committee and may not be allocated to a different committee.

Each NYSE listed company must have an internal audit function. The commentary to NYSE Rule 303A.07 states that listed companies must maintain an internal audit function to provide management and the audit committee with ongoing assessments of the NYSE listed company’s risk management processes and system of internal control. A NYSE listed company may choose to outsource this function to a third party service provider other than its independent auditor.

3. NASDAQ.

(a) Audit Committee Composition. NASD Rule 4350(d) requires each NASDAQ listed issuer to have an audit committee composed of at least three members. In addition, it requires each audit committee member to: (1) be independent, as defined under NASD Rule 4200(a)(15); (2) meet the criteria for independence set forth in 1934 Act Rule 10A-3 (subject to the exceptions provided in 1934 Act Rule 10A-3(c)); (3) not have participated in the preparation of the financial statements of the company or any current subsidiary of the company at any time during the past three years; and (4) be able to read and understand fundamental financial statements, including a company’s balance sheet, income statement, and cash flow statement (“NASDAQ Audit Committee Provision”).

One director who is not independent as defined in NASD Rule 4200(a)(15) and meets the criteria set forth in 1934 Act § 10A(m)(3) and the rules thereunder, and is not a current officer or employee of the company or a family member of such person, may be appointed to the audit committee if the Board, under exceptional and limited circumstances, determines that membership on the committee by the individual is required by the best interests of the company and its shareholders, and the Board discloses, in the next annual proxy statement subsequent to such determination (or, if the issuer does not file a proxy, in its Form 10-K or 20-F), the nature of

the relationship and the reasons for that determination. A member appointed under this exception would not be permitted to serve longer than two years and would not be permitted to chair the audit committee. The NASDAQ Interpretive Material recommends that an issuer disclose in its annual proxy (or, if the issuer does not file a proxy, in its Form 10-K or 20-F) if any director is deemed independent but falls outside the safe harbor provisions of SEC Rule 10A-3(e)(1)(ii).

At least one member of the audit committee must have past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities.

(b) Audit Committee Charter and Responsibilities. NASD Rule 4350(d) requires each NASDAQ listed company to adopt a formal written audit committee charter and to review and reassess the adequacy of the formal written charter on an annual basis. The charter must specify: (1) the scope of the audit committee's responsibilities, and how it carries out those responsibilities, including structure, processes, and membership requirements; (2) the audit committee's responsibility for ensuring its receipt from the outside auditors of a formal written statement delineating all relationships between the auditor and the company, and the audit committee's responsibility for actively engaging in a dialogue with the auditor with respect to any disclosed relationships or services that may impact the objectivity and independence of the auditor and for taking, or recommending that the full Board take, appropriate action to oversee the independence of the outside auditor; (3) the committee's purpose of overseeing the accounting and financial reporting processes of the issuer and the audits of the financial statements of the issuer; and (4) other specific audit committee responsibilities and authority set forth in NASD Rule 4350(d)(3). NASDAQ states in the NASDAQ Interpretive Material to NASD Rule 4350(d) that the written charter sets forth the scope of the audit committee's responsibilities and the means by which the committee carries out those responsibilities; the outside auditor's accountability to the committee; and the committee's responsibility to ensure the independence of the outside auditors.

C. Nominating Committee Member Independence.

1. NYSE. NYSE Rule 303A.04 requires each NYSE listed company to have a nominating/corporate governance committee composed entirely of independent directors. The nominating/corporate governance committee must have a written charter that addresses, among other items, the committee's purpose and responsibilities, and an annual performance evaluation of the nominating/corporate governance committee ("NYSE Nominating/Corporate Governance Committee Provision"). The committee is required to identify individuals qualified to become board members, consistent with the criteria approved by the board.

2. NASDAQ. NASD Rule 4350(c)(4)(A) requires director nominees to be selected, or recommended for the board's selection, either by a majority of independent directors, or by a nominations committee comprised solely of independent directors ("NASDAQ Director Nomination Provision").

If the nominations committee is comprised of at least three members, one director, who is not independent (as defined in NASD Rule 4200(a)(15)) and is not a current officer or employee or a family member of such person, is permitted to be appointed to the committee if the board, under exceptional and limited circumstances, determines that such individual's membership on the committee is required by the best interests of the company and its shareholders, and the board discloses, in its next annual meeting proxy statement subsequent to such determination (or, if the issuer does not file a proxy, in its Form 10-K or 20-F), the nature of the relationship and the reasons for the determination. A member appointed under such exception is not permitted to serve longer than two years.

Further, NASD Rule 4350(c)(4)(B) requires each NASDAQ listed company to certify that it has adopted a formal written charter or Board resolution, as applicable, addressing the nominations process and such related matters as may be required under the federal securities laws. The NASDAQ Director Nomination Provision does not apply in cases where either the right to nominate a director legally belongs to a third party, or the company is subject to a binding obligation that requires a director nomination structure inconsistent with this provision and such obligation pre-dates the date the provision was approved.

D. Compensation Committee Member Independence.

1. NYSE. NYSE Rule 303A.05 requires each NYSE listed company to have a compensation committee composed entirely of independent directors. The compensation committee must have a written charter that addresses, among other items, the committee's purpose and responsibilities, and an annual performance evaluation of the compensation committee ("*NYSE Compensation Committee Provision*"). The Compensation Committee is required to produce a compensation committee report on executive compensation, as required by SEC rules, to be included in the company's annual proxy statement or annual report on Form 10-K filed with the SEC. NYSE Rule 303A.05 provides that either as a committee or together with the other independent directors (as directed by the Board), the committee will determine and approve the CEO's compensation level based on the committee's evaluation of the CEO's performance. The commentary to this rule indicates that discussion of CEO compensation with the Board generally is not precluded. The Board or compensation committee of an NYSE or NASDAQ-listed company may hire any compensation consultant, legal counsel or other adviser that it wishes, whether or not independent, but must take into consideration the six factors enumerated in 1934 Act Rule 10C-1(b)(4), and, for NYSE-listed companies, any other factors relevant to that adviser's independence from management, before engaging such an adviser.

2. NASDAQ. NASD Rule 4350(c)(3) requires the compensation of the CEO of a NASDAQ listed company to be determined or recommended to the Board for determination either by a majority of the independent directors, or by a compensation committee comprised solely of independent directors ("*NASDAQ Compensation of Executives Provision*"). The CEO may not be present during voting or deliberations. In addition, the compensation of all other officers has to be determined or recommended to the Board for determination either by a majority of the independent directors, or a compensation committee comprised solely of independent directors.

Under these NASD Rules, if the compensation committee is comprised of at least three members, one director, who is not “*independent*” (as defined in NASD Rule 4200(a)(15)) and is not a current officer or employee or a family member of such person, is permitted to be appointed to the committee if the Board, under exceptional and limited circumstances, determines that such individual’s membership on the committee is required by the best interests of the company and its shareholders, and the Board discloses, in the next annual meeting proxy statement subsequent to such determination (or, if the issuer does not file a proxy statement, in its Form 10-K or 20-F), the nature of the relationship and the reasons for the determination. A member appointed under such exception would not be permitted to serve longer than two years.

E. State Law.

Under state law and unlike the SOX rules, director independence is not considered as a general status, but rather is tested in the context of each specific matter on which the director is called upon to take action.

Under Texas common law, a director is generally considered “*interested*” only in respect of matters in which he has a financial interest. The Fifth Circuit in *Gearhart* summarized Texas law with respect to the question of whether a director is “*interested*” as follows:

A director is considered “interested” if he or she (1) makes a personal profit from a transaction by dealing with the corporation or usurps a corporate opportunity . . .; (2) buys or sells assets of the corporation . . .; (3) transacts business in his director’s capacity with a second corporation of which he is also a director or significantly financially associated . . .; or (4) transacts business in his director’s capacity with a family member.²⁰

In the context of the dismissal of a derivative action on motion of the corporation, those making the decision on behalf of the corporation to dismiss the proceeding must lack both any disqualifying financial interest and any relationships that would impair independent decision making.²¹ The Texas Corporate Statutes provide that a court shall dismiss a derivative action if the determination to dismiss is made by directors who are both disinterested and independent.²² For this purpose, a director is considered “*disinterested*”²³ if he lacks any disqualifying financial

²⁰ *Gearhart Indus., Inc. v. Smith Int’l, Inc.*, 741 F.2d 707, 719-20 (5th Cir. 1984) (citations omitted).

²¹ *Johnson v. Jackson Walker, L.L.P.*, 247 S.W.3d 765, 774 (Tex. App.—Dallas 2008, pet. denied).

²² TBOC § 21.554, 21.558; TBCA art. 5.14(F) and 5.14(H).

²³ TBOC § 1.003 defines “*disinterested*” as follows:

Sec. 1.003. Disinterested Person.

(a) For purposes of this code, a person is disinterested with respect to the approval of a contract, transaction, or other matter or to the consideration of the disposition of a claim or challenge relating to a contract, transaction, or particular conduct, if the person or the person’s associate:

(1) is not a party to the contract or transaction or materially involved in the conduct that is the subject of the claim or challenge; and

(2) does not have a material financial interest in the outcome of the contract or transaction or the disposition of the claim or challenge.

interest in the matter, and is considered “*independent*”²⁴ if he is both disinterested and lacks any other specified relationships that could be expected to materially and adversely affect his judgment as to the disposition of the matter.

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- (b) For purposes of Subsection (a), a person is not materially involved in a contract or transaction that is the subject of a claim or challenge and does not have a material financial interest in the outcome of a contract or transaction or the disposition of a claim or challenge solely because:
- (1) the person was nominated or elected as a governing person by a person who is:
 - (A) interested in the contract or transaction; or
 - (B) alleged to have engaged in the conduct that is the subject of the claim or challenge;
 - (2) the person receives normal fees or customary compensation, reimbursement for expenses, or benefits as a governing person of the entity;
 - (3) the person has a direct or indirect equity interest in the entity;
 - (4) the entity has, or its subsidiaries have, an interest in the contract or transaction or was affected by the alleged conduct;
 - (5) the person or an associate of the person receives ordinary and reasonable compensation for reviewing, making recommendations regarding, or deciding on the disposition of the claim or challenge; or
 - (6) in the case of a review by the person of the alleged conduct that is the subject of the claim or challenge:
 - (A) the person is named as a defendant in the derivative proceeding regarding the matter or as a person who engaged in the alleged conduct; or
 - (B) the person, acting as a governing person, approved, voted for, or acquiesced in the act being challenged if the act did not result in a material personal or financial benefit to the person and the challenging party fails to allege particular facts that, if true, raise a significant prospect that the governing person would be held liable to the entity or its owners or members as a result of the conduct.

TBCA art. 1.02(A)(12) provides substantially the same.

²⁴ TBOC § 1.004 defines “*independent*” as follows:

Sec. 1.004. Independent Person.

- (a) For purposes of this code, a person is independent with respect to considering the disposition of a claim or challenge regarding a contract or transaction, or particular or alleged conduct, if the person:
- (1) is disinterested;
 - (2) either:
 - (A) is not an associate, or member of the immediate family, of a party to the contract or transaction or of a person who is alleged to have engaged in the conduct that is the subject of the claim or challenge; or
 - (B) is an associate to a party or person described by Paragraph (A) that is an entity if the person is an associate solely because the person is a governing person of the entity or of the entity’s subsidiaries or associates;
 - (3) does not have a business, financial, or familial relationship with a party to the contract or transaction, or with another person who is alleged to have engaged in the conduct, that is the subject of the claim or challenge that could reasonably be expected to materially and adversely affect the judgment of the person in favor of the party or other person with respect to the consideration of the matter; and

Under Delaware law, an “*independent director*” is one whose decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influence.²⁵ The Delaware Supreme Court’s teachings on independence can be summarized as follows:

At bottom, the question of independence turns on whether a director is, *for any substantial reason*, incapable of making a decision with only the best interests of the corporation in mind. That is, the Supreme Court cases ultimately focus on impartiality and objectivity.²⁶

The Delaware focus includes both financial and other disabling interests.²⁷ In the words of the Chancery Court:

Delaware law should not be based on a reductionist view of human nature that simplifies human motivations on the lines of the least sophisticated notions of

(4) is not shown, by a preponderance of the evidence, to be under the controlling influence of a party to the contract or transaction that is the subject of the claim or challenge or of a person who is alleged to have engaged in the conduct that is the subject of the claim or challenge.

(b) For purposes of Subsection (a), a person does not have a relationship that could reasonably be expected to materially and adversely affect the judgment of the person regarding the disposition of a matter that is the subject of a claim or challenge and is not otherwise under the controlling influence of a party to a contract or transaction that is the subject of a claim or challenge or that is alleged to have engaged in the conduct that is the subject of a claim or challenge solely because:

(1) the person has been nominated or elected as a governing person by a person who is interested in the contract or transaction or alleged to be engaged in the conduct that is the subject of the claim or challenge;

(2) the person receives normal fees or similar customary compensation, reimbursement for expenses, or benefits as a governing person of the entity;

(3) the person has a direct or indirect equity interest in the entity;

(4) the entity has, or its subsidiaries have, an interest in the contract or transaction or was affected by the alleged conduct;

(5) the person or an associate of the person receives ordinary and reasonable compensation for reviewing, making recommendations regarding, or deciding on the disposition of the claim or challenge; or

(6) the person, an associate of the person, other than the entity or its associates, or an immediate family member has a continuing business relationship with the entity that is not material to the person, associate, or family member.

TBCA art. 1.02(A)(15) provides substantially the same.

²⁵ *Aronson v. Lewis*, 473 A.2d 805, 816 (Del. 19784), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244, 253-54 (Del. 2000); *Odyssey Partners v. Fleming Cos.*, 735 A.2d 386, 407 (Del. Ch. 1999).

²⁶ *Parfi Holding AB v. Mirror Image Internet, Inc.*, 794 A.2d 1211, 1232 (Del. Ch. 2001) (footnotes omitted) (emphasis in original), *rev’d in part on other grounds*, 817 A.2d 149 (Del. 2002), *cert. denied*, 123 S. Ct. 2076 (2003).

²⁷ *See In re infoUSA, Inc. S’holders Litig.*, 953 A.2d 963, 992 (Del. Ch. 2007) (mere allegations of personal liability in respect of challenged activities are not sufficient to impair independence, but independence may be found lacking where there is a substantial likelihood that liability will be found).

the law and economics movement. *Homo sapiens* is not merely *homo economicus*. We may be thankful that an array of other motivations exist that influence human behavior; not all are any better than greed or avarice, think of envy, to name just one. But also think of motives like love, friendship, and collegiality, think of those among us who direct their behavior as best they can on a guiding creed or set of moral values.²⁸

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In re Oracle Corp. Derivative Litig., 824 A.2d 917, 920 (Del. Ch. 2003). In *Oracle*, the Chancery Court denied a motion by a special litigation committee of Oracle Corporation to dismiss pending derivative actions which accused four Oracle directors and officers of breaching their fiduciary duty of loyalty by misappropriating inside information in selling Oracle stock while in possession of material, nonpublic information that Oracle would not meet its projections. These four directors were Oracle's CEO, its CFO, the Chair of the Executive, Audit and Finance Committees, and the Chair of the Compensation Committee who was also a tenured professor at Stanford University. The other members of Oracle's board were accused of a breach of their *Caremark* duty of oversight through indifference to the deviation between Oracle's earnings guidance and reality.

In response to this derivative action and a variety of other lawsuits in other courts arising out of its surprising the market with a bad earnings report, Oracle created a special litigation committee to investigate the allegations and decide whether Oracle should assume the prosecution of the insider trading claims or have them dismissed. The committee consisted of two new outside directors, both tenured Stanford University professors, one of whom was former SEC Commissioner Joseph Grundfest. The new directors were recruited by the defendant CFO and the defendant Chair of Compensation Committee/Stanford professor after the litigation had commenced and to serve as members of the special litigation committee.

The Chancery Court held that the special committee failed to meet its burden to prove that no material issue of fact existed regarding the special committee's independence due to the connections that both the committee members and three of four defendants had to Stanford. One of the defendants was a Stanford professor who taught special committee member Grundfest when he was a Ph.D. candidate, a second defendant was an involved Stanford alumnus who had contributed millions to Stanford, and the third defendant was Oracle's CEO who had donated millions to Stanford and was considering a \$270 million donation at the time the special committee members were added to the Oracle board. The two Stanford professors were tenured and not involved in fund raising for Stanford, and thus were not dependent on contributions to Stanford for their continued employment.

The Court found troubling that the special litigation committee's report recommending dismissal of the derivative action failed to disclose many of the Stanford ties between the defendants and the special committee. The ties emerged during discovery.

Without questioning the personal integrity of either member of the special committee, the Court found that interrelationships among Stanford University, the special committee members and the defendant Oracle directors and officers necessarily would have colored in some manner the special committee's deliberations. The Court commented that it is no easy task to decide whether to accuse a fellow director of the serious charge of insider trading and such difficulty was compounded by requiring the committee members to consider accusing a fellow professor and two large benefactors of their university of conduct that is rightly considered a violation of criminal law.

The Chancery Court wrote that the question of independence "turns on whether a director is, for any substantial reason, incapable of making a decision with only the best interests of the corporation in mind." *Id.* at 920 (citations omitted). That is, the independence test ultimately "focus[es] on impartiality and objectivity." *Id.* (citations omitted). While acknowledging a difficulty in reconciling Delaware precedent, the Court declined to focus narrowly on the economic relationships between the members of the special committee and the defendant officers and directors - *i.e.* "treating the possible effect on one's personal wealth as the key to an independence inquiry." *Id.* at 936. Commenting that "*homo sapiens* is not merely *homo economicus*," the Chancery Court wrote, "Whether the [special committee] members had precise knowledge of all the facts that have emerged is not essential, what is important is that by any measure this

Delaware draws a distinction between director disinterest and director independence. A director is “*interested*” when he or she stands on both sides of a transaction, or will benefit or experience some detriment that does not flow to the corporation or the stockholders generally. Absent self-dealing, the benefit must be material to the individual director.²⁹ In contrast, a director is not “*independent*” where the director’s decision is based on “extraneous considerations or influences” and not on the “corporate merits of the subject.”³⁰ Employment or consulting relationships can impair independence.³¹ A director who is a partner of a law firm that receives substantial fees from the corporation may not be independent.³² Family

was a social atmosphere painted in too much vivid Stanford Cardinal red for the [special committee] members to have reasonably ignored.” *Id.* at 938, 947.

²⁹ *Orman v. Cullman*, 794 A.2d 5, 23 (Del. Ch. 2002).

³⁰ *Id.* at 24.

³¹ *See In re Ply Gem Indus., Inc. S’holders Litig.*, C.A. No. 15779-NC, 2001 Del. Ch. LEXIS 84, at *25 (Del. Ch. 2001) (holding plaintiffs raised reasonable doubt as to directors’ independence where (i) interested director as Chairman of the Board and CEO was in a position to exercise considerable influence over directors serving as President and COO; (ii) director was serving as Executive Vice President; (iii) a director whose small law firm received substantial fees over a period of years; and (iv) directors receiving substantial consulting fees); *Goodwin v. Live Entm’t, Inc.*, C.A. No. 15765, 1999 WL 64265, at *25 (Del. Ch. Jan. 25, 1999) (stating on motion for summary judgment that evidence produced by plaintiff generated a triable issue of fact regarding whether directors’ continuing employment relationship with surviving entity created a material interest in merger not shared by the stockholders); *Orman*, 794 A.2d at 13 (questioning the independence of one director who had a consulting contract with the surviving corporation and questioning the disinterestedness of another director whose company would earn a \$3.3 million fee if the deal closed); *In re The Ltd., Inc. S’holders Litig.*, C.A. No. 17148-NC, 2002 Del. Ch. LEXIS 28, at *11 (Del. Ch. March 27, 2002) (finding, in context of demand futility analysis, that the plaintiffs cast reasonable doubt on the independence of certain directors in a transaction that benefited the founder, Chairman, CEO and 25% stockholder of the company, where one director received a large salary for his management positions in the company’s wholly-owned subsidiary, one director received consulting fees, and another director had procured, from the controlling stockholder, a \$25 million grant to the university where he formerly served as president); *Biondi v. Scrushy*, 820 A.2d 1148, 1157 (Del. Ch. 2003) (questioning the independence of two members of a special committee formed to investigate charges against the CEO because committee members served with the CEO as directors of two sports organizations and because the CEO and one committee member had “long-standing personal ties” that included making large contributions to certain sports programs); *In re infoUSA, Inc. S’holders Litig.*, 953 A.2d 963, 986 (Del. Ch. 2007) (finding, in a case where self dealing transactions by 41% stockholder were challenged on duty of loyalty grounds, independence lacking as to (i) director who was a professor in university business school named after the 41% stockholder and received substantial compensation from the university and (ii) directors who received free office space from the company for non-company uses); *New Jersey Carpenters Pension Fund v. infoGROUP, Inc.*, C.A. No. 5334-VCN, 2011 Del. Ch. LEXIS 147, at *35 (Del. Ch. Sept. 30, 2011, revised Oct. 6, 2011) (held “extraneous considerations and influences may exist when the challenged director is controlled by another. Control may be shown by the pleading of facts that establish ‘that the directors are . . . so under their influence that their discretion would be sterilized.’ Control may also occur where a director is in fact dominated by another party, and domination can occur through force of will” in absence of family or financial interests); *but see In re Alloy, Inc. Shareholder Litigation*, C.A. No. 5626-VCP, 2011 Del. Ch. LEXIS 159, at *4 (Del. Ch. Oct. 13, 2011) (post closing, court granted motion to dismiss a class action challenging a going-private transaction, finding that independence of nine-member Board not compromised where two directors retained senior management positions and received equity interest in the surviving corporation, because they did not dominate or control the seven independent directors, even where the two directors owned 15% of stock).

³² *In re infoUSA*, 953 A.2d at 991 (finding the threat of withdrawal of legal business to be enough to raise a reasonable doubt as to a director’s independence where annual payments listed in the complaint come close

relationships can also impair independence.³³ Other business relationships may also prevent independence.³⁴

A controlled director is not an independent director.³⁵ Control over individual directors is established by facts demonstrating that “through personal or other relationships the directors are beholden to the controlling person.”³⁶

to or exceed a reasonable estimate of the annual yearly income per partner of the law firm; the Court commented:

“Legal partnerships normally base the pay and prestige of their members upon the amount of revenue that partners (and, more importantly, their clients) bring to their firms. Indeed, with law becoming an ever-more competitive business, there is a notable trend for partners who fail to meet expectations to risk a loss of equity in their firms. The threat of withdrawal of one partner’s worth of revenue from a law firm is arguably sufficient to exert considerable influence over a named partner such that . . . his independence may be called into question.”)

³³ See *Chaffin v. GNI Group, Inc.*, C.A. No. 16211, 1999 Del. Ch. LEXIS 182, at *13 (Del. Ch. Sept. 3, 1999) (finding that director lacked independence where a transaction benefited son financially); *Harbor Fin. Partners v. Huizenga*, 751 A.2d 879, 889 (Del. Ch. 1999) (holding that director who was brother-in-law of CEO and involved in various businesses with CEO could not impartially consider a demand adverse to CEO’s interests); *Mizel v. Connelly*, C.A. No. 16638, 1999 Del. Ch. LEXIS 157, at *1 (Del. Ch. July 22, 1999) (holding director could not objectively consider demand adverse to interest of grandfather).

³⁴ See *Kahn v. Tremont Corp.*, 694 A.2d 422, 429-30 (Del. 1997) (holding members of special committee had significant prior business relationship with majority stockholder such that the committee lacked independence triggering entire fairness); *Heineman v. Datapoint Corp.*, 611 A.2d 950, 955 (Del. 1992) (holding that allegations of “extensive interlocking business relationships” did not sufficiently demonstrate the necessary “nexus” between the conflict of interest and resulting personal benefit necessary to establish directors’ lack of independence) (overruled as to standard of appellate review); see *Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 55 (Del. 1989) (holding mere fact that a controlling stockholder elects a director does not render that director non-independent).

³⁵ *In re MAXXAM, Inc.*, 659 A.2d 760, 773 (Del. Ch. 1995) (“To be considered independent, a director must not be dominated or otherwise controlled by an individual or entity interested in the transaction.”).

³⁶ *Aronson v. Lewis*, 473 A.2d 805, 815; compare *In re The Limited, Inc. S’holders Litig.*, 2002 Del. Ch. LEXIS 28, at *27 (Del. Ch. Mar. 27, 2002) (concluding that a university president who had solicited a \$25 million contribution from a corporation’s President, Chairman and CEO was not independent of that corporate official in light of the sense of “owingness” that the university president might harbor with respect to the corporate official), and *Lewis v. Fuqua*, 502 A.2d 962, 966-67 (Del. Ch. 1985) (finding that a special litigation committee member was not independent where the committee member was also the president of a university that received a \$10 million charitable pledge from the corporation’s CEO and the CEO was a trustee of the university), with *In re Walt Disney Co. Derivative Litig.*, 731 A.2d 342, 359 (Del. Ch. 1998) (deciding that the plaintiffs had not created reasonable doubt as to a director’s independence where a corporation’s Chairman and CEO had given over \$1 million in donations to the university at which the director was the university president and from which one of the CEO’s sons had graduated), *aff’d in part, rev’d in part sub nom.* See *Brehm v. Eisner*, 746 A.2d 244, 248 (Del. 2000); and *Beam v. Martha Stewart*, 845 A.2d 1040, 1054 (Del. 2004) (“bare social relationships clearly do not create reasonable doubt of independence”). The Delaware Supreme Court in distinguishing *Beam* from *Oracle*, wrote “[u]nlike the demand-excusal context [of *Beam*], where the board is presumed to be independent, the SLC [special litigation committee in *Oracle*] has the burden of establishing its own independence by a yardstick that must be ‘like Caesar’s wife’ – ‘above reproach.’ Moreover, unlike the presuit demand context, the SLC analysis contemplates not only a shift in the burden of persuasion but also the availability of discovery into various issues, including independence.”). *Beam*, 845 A.2d at 1055.

4. Compensation.

(a) Prohibition on Loans to Directors or Officers. SOX § 402 generally prohibits a corporation from directly or indirectly making or arranging for personal loans to its directors and executive officers.³⁷ Four categories of personal loans by an issuer to its directors and officers are expressly exempt from SOX § 402's prohibition:³⁸

(1) any extension of credit existing before SOX's enactment as long as no material modification or renewal of the extension of credit occurs on or after the date of SOX's enactment (July 30, 2002);

(2) specified home improvement and consumer credit loans if:

- made in the ordinary course of the issuer's consumer credit business,
- of a type generally made available to the public by the issuer, and
- on terms no more favorable than those offered to the public;

(3) loans by a broker-dealer to its employees that:

- fulfill the three conditions of paragraph (2) above,
- are made to buy, trade or carry securities other than the broker-dealer's securities, and
- are permitted by applicable Federal Reserve System regulations; and

(4) loans made or maintained by depository institutions that are insured by the U.S. Federal Deposit Insurance Corporation "if the loans are subject to the insider lending restrictions of section 22(h) of the Federal Reserve Act (12 U.S.C. 375b)."³⁹

³⁷ SOX § 402(a) provides: "It shall be unlawful for any issuer (as defined in [SOX § 2]), directly or indirectly, including through any subsidiary, to extend or maintain credit, to arrange for the extension of credit, or to renew an extension of credit, in the form of a personal loan to or for any director or executive officer (or equivalent thereof) of that issuer. An extension of credit maintained by the issuer on the date of enactment of this subsection shall not be subject to the provisions of this subsection, provided that there is no material modification to any term of any such extension of credit or any renewal of any such extension of credit on or after that date of enactment."

³⁸ SEC Foreign Bank Exemption from The Insider Lending Prohibition of Exchange Act Section 13(k), Exchange Act Release No. 48,481, 81 S.E.C. Docket 107 (September 11, 2003), *available at* <http://www.sec.gov/rules/proposed/34-48481.htm>.

³⁹ This last exemption applies only to an "insured depository institution," which is defined by the Federal Deposit Insurance Act ("FDIA") as a bank or savings association that has insured its deposits with the Federal Deposit Insurance Corporation ("FDIC"). Although this SOX § 402 provision does not explicitly exclude foreign banks from the exemption, under current U.S. banking regulation a foreign bank cannot be an "insured depository institution" and, therefore, cannot qualify for the bank exemption. Since 1991, following enactment of the Foreign Bank Supervision Enhancement Act ("FBSEA"), a foreign bank that seeks to accept and maintain FDIC-insured retail deposits in the United States must establish a U.S.

The SEC to date has not provided guidance as to the interpretation of SOX § 402, although a number of interpretative issues have surfaced. The prohibitions of SOX § 402 apply only to an extension of credit “in the form of a personal loan” which suggests that all extensions of credit to a director or officer are not proscribed. While there is no legislative history or statutory definition to guide, it is reasonable to take the position that the following in the ordinary course of business are not proscribed: travel and similar advances, ancillary personal use of company credit card or company car where reimbursement is required; advances of relocation expenses ultimately to be borne by the issuer; stay and retention bonuses subject to reimbursement if the employee leaves prematurely; advancement of expenses pursuant to typical charter, bylaw or contractual indemnification arrangements; and tax indemnification payments to overseas-based officers.⁴⁰

SOX § 402 raises issues with regard to cashless stock option exercises and has led a number of issuers to suspend cashless exercise programs. In a typical cashless exercise program, the optionee delivers the notice of exercise to both the issuer and the broker, and the broker executes the sale of some or all of the underlying stock on that day (T). Then, on or prior to the settlement date (T+3), the broker pays to the issuer the option exercise price and applicable withholding taxes, and the issuer delivers (i.e., issues) the option stock to the broker. The broker transmits the remaining sale proceeds to the optionee. When and how these events occur may determine the level of risk under SOX § 402.⁴¹ The real question is whether a broker-administered same-day sale involves “an extension of credit in the form of a personal loan” made or arranged by the issuer. The nature of the arrangement can affect the analysis.⁴²

subsidiary, rather than a branch, agency or other entity, for that purpose. These U.S. subsidiaries of foreign banks, and the limited number of grandfathered U.S. branches of foreign banks that had obtained FDIC insurance prior to FBSEA’s enactment, can engage in FDIC-insured, retail deposit activities and, thus, qualify as “insured depository institutions.” But the foreign banks that own the U.S. insured depository subsidiaries or operate the grandfathered insured depository branches are not themselves “insured depository institutions” under the FDIA. The SEC, however, has proposed a rule to address this disadvantageous situation for foreign banks.

⁴⁰ See the outline dated October 15, 2002, authored jointly by a group of 25 law firms and posted at www.TheCorporateCounsel.net as “Sarbanes-Oxley Act: Interpretative Issues Under § 402 – Prohibition of Certain Insider Loans.”

⁴¹ See *Cashless Exercise and Other SOXmania*, The Corporate Counsel (September-October 2002).

⁴² If the issuer delivers the option stock to the broker before receiving payment, the issuer may be deemed to have loaned the exercise price to the optionee, perhaps making this form of program riskier than others. If the broker advances payment to the issuer prior to T+3, planning to reimburse itself from the sale of proceeds on T+3, that advance may be viewed as an extension of credit by the broker, and the question then becomes whether the issuer “arranged” the credit. The risk of this outcome may be reduced where the issuer does not select the selling broker or set up the cashless exercise program, but instead merely confirms to a broker selected by the optionee that the option is valid and exercisable and that the issuer will deliver the stock upon receipt of the option exercise price and applicable withholding taxes. Even where the insider selects the broker, the broker cannot, under Regulation T, advance the exercise price without first confirming that the issuer will deliver the stock promptly. In that instance, the issuer’s involvement is limited to confirming facts, and therefore is less likely to be viewed as “arranging” the credit.

Where both payment and delivery of the option stock occur on the same day (T+3), there arguably is no extension of credit at all, in which case the exercise should not be deemed to violate SOX § 402 whether effected through a designated broker or a broker selected by the insider.

Some practitioners have questioned whether SOX § 402 prohibits directors and executive officers of an issuer from taking loans from employee pension benefit plans, which raised the further question of whether employers could restrict director and officer plan loans without violating the U.S. Labor Department's antidiscrimination rules. On April 15, 2003, the Labor Department issued Field Assistance Bulletin 2003-1 providing that plan fiduciaries of public companies could deny participant loans to directors and officers without violating the Labor Department rules. On March 4, 2013, the SEC issued interpretative guidance in response to a no-action letter in which staff wrote that a particular structure of equity-based incentive compensation would not violate SOX § 402.⁴³

(b) Stock Exchange Requirements. The stock exchanges require shareholder approval of many equity compensation plans.⁴⁴ In contrast, state law generally authorizes such plans and leaves the power to authorize them generally with the power of the board of directors to direct the management of the affairs of the corporation.

(c) Fiduciary Duties. In approving executive compensation, directors must act in accordance with their fiduciary duties. As in other contexts, process and disinterested judgment are critical.

5. Related Party Transactions.

(a) Stock Exchanges.

(1) General. Stock exchange listing requirements generally require all related party transactions to be approved by a committee of independent directors.⁴⁵

(2) NYSE. The NYSE, in NYSE Rule 307, takes the general position that a publicly-owned company of the size and character appropriate for listing on the NYSE should be able to operate on its own merit and credit standing free from the suspicions that may arise when business transactions are consummated with insiders. The NYSE feels that the company's

If the insider has sufficient collateral in his or her account (apart from the stock underlying the option being exercised) to permit the broker to make a margin loan equal to the exercise price and applicable withholding taxes, arguably the extension of credit is between the broker and the insider, and does not violate SOX § 402 assuming the issuer is not involved in arranging the credit.

⁴³ RingsEnd Partners, LLC, SEC No-Action Letter, 2013 WL 860508 (Mar. 4, 2013). The program in question would allow employees that receive restricted stock awards to elect to be taxed on those shares when granted, and then place those shares into a trust. That trust would then use the shares as collateral to borrow funds from an independent bank via non-recourse loans. Those loans would then be used to pay any tax liability generated by the stock awards, purchase additional shares of stock, and eventually, repay the loans and distribute the remaining shares to the employee. The SEC staff confirmed that such a program would not constitute the company extending or arranging credit in violation of SOX § 402, and furthermore, that it would not be a violation for the issuer to undertake certain ministerial or administrative activities in accordance with such programs. RingsEnd noted that the program was designed to avoid a "tax-based incentive to sell awarded shares" and incentivize employees to hold award shares for a longer period.

⁴⁴ See NYSE Rule 312; NASD Rule 4350(i).

⁴⁵ See NYSE Rules 307, 312; NASD Rule 4350(h).

management is in the best position to evaluate each such relationship intelligently and objectively.

However, there are certain related party transactions that do require shareholder approval under the NYSE Rules. Therefore, a review of NYSE Rule 312 should be done whenever related party transactions are analyzed by a NYSE listed company.

(3) NASDAQ. NASD Rule 4350(h) requires each NASDAQ listed company to conduct an appropriate review of all related party transactions for potential conflict of interest situations on an ongoing basis and all such transactions must be approved by the company's audit committee or another independent body of the board of directors. For purposes of this rule, the term "related party transaction" shall refer to transactions required to be disclosed pursuant to SEC Regulation S-K, Item 404.

(b) Interested Director Transactions—TBOC § 21.418 and DGCL § 144. Both Texas and Delaware have embraced the principle that a transaction or contract between a director or officer and the corporation served is presumed to be valid and will not be voidable solely by reason of the interest of the director or officer as long as certain conditions are met.

APPENDIX E

SHAREHOLDER RIGHTS PLANS

A. Rights Plans.

The Basic Design. A typical Rights Plan provides for the issuance and distribution to shareholders of rights (“*Rights*”) to purchase common stock or preferred stock of the corporation that, when triggered by a non-Board-approved outside acquirer becoming the beneficial owner¹ of more than a specified percentage (typically 10-20%) of the corporation’s common stock, would give the holder of each share of common stock (other than those held by the acquirer) the right to purchase additional shares of common stock at a significant discount (typically 50%). The typical Rights Plan reserves to the Board the right to redeem the Rights for a nominal amount at any time before the Rights are triggered, and this power to redeem the Rights gives the Board tremendous power to negotiate with the would be acquirer. The goal of the Rights Plan is to deter acquisitions not approved by the Board by imposing unacceptable levels of dilution on potential acquirers, thus channeling the negotiation of any potential acquisition through the Board. Adoption of the Rights Plan by no means makes the corporation invulnerable to takeover. There is nothing in a Rights Plan to prevent an acquirer from launching an election contest to replace the current Board with new directors who would elect to redeem the Rights Plan, allowing the acquirer to consummate an acquisition without risk of dilution. The adoption of the Rights Plan, however, gives the acquirer a powerful incentive to negotiate with the Board and enhances the Board’s ability to pursue value maximizing alternatives rather than succumbing to a hostile takeover bid that may not be in the best interests of the corporation or its shareholders. A Rights Plan can buy the Board time to evaluate potential offers and seek maximum value for the shareholders.

Adoption of the Rights Plan. As a first step, the Board will adopt resolutions approving and adopting the Rights Plan itself. It can be implemented without shareholder action or approval. Much like a stock option or other equity incentive plan, the Rights Plan defines the rights of a class of persons to receive a specified class of securities. Each Right would give its holder the option to purchase one share of the corporation’s common stock (or preferred stock convertible into common stock) at a price per share determined by the Board.

Authorization of Issuance and Distribution of Rights. Once the Rights Plan has been approved by the Board, the Board must take steps to actually issue and distribute the Rights to the Company’s shareholders. This is done by the Board adopting resolutions authorizing the issuance and distribution to shareholders of one Right for every share of common stock issued and outstanding. The Rights would be issued and distributed to all shareholders—even the potential acquirer—but would, again, only be exercisable once triggered, and then only by shareholders other than the acquirer.

¹ See *infra* notes 2-6 and related text. See also Joseph M. Grieco, *The Ever-Evolving Poison Pill: The Pill in Asset Protection and Closely-Held Corporation Cases*, 36 DEL. J. CORP. L. 625 (2011).

The Triggering Event. The Rights would be designed so as to only be exercisable if “triggered” when a potential acquirer becomes the beneficial owner of a certain threshold percentage of the corporation’s stock, and would be exercisable by all shareholders *except* the triggering acquirer.² Thus, definition of the triggering event is key, as it determines when and by whom the Rights will be exercisable and, more importantly, exactly who will be deterred from attempting to acquire control of the corporation without Board approval. Under a Rights Plan, the exercisability of the Rights will be triggered as soon as a person, together with its affiliates and associates, becomes an “*Acquiring Person*” by acquiring beneficial ownership (generally a defined term similar to, but more inclusive than, Rules 13d-3 and 13d-5 under the 1934 Act³) of a specified percentage of the common stock then outstanding.⁴

² TBOC § 21.169 specifically provides for selective treatments of different classes of shareholders in this manner.

³ Rules 13d-3 and 13d-5 under the 1934 Act provide as follows:

Rule 13d-3. Determination of beneficial owner.

(a) For the purposes of sections 13(d) and 13(g) of the Act a beneficial owner of a security includes any person who, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise has or shares:

(1) Voting power which includes the power to vote, or to direct the voting of, such security; and/or,

(2) Investment power which includes the power to dispose, or to direct the disposition of, such security.

(b) Any person who, directly or indirectly, creates or uses a trust, proxy, power of attorney, pooling arrangement or any other contract, arrangement, or device with the purpose or effect of divesting such person of beneficial ownership of a security or preventing the vesting of such beneficial ownership as part of a plan or scheme to evade the reporting requirements of section 13(d) or (g) of the Act shall be deemed for purposes of such sections to be the beneficial owner of such security.

(c) All securities of the same class beneficially owned by a person, regardless of the form which such beneficial ownership takes, shall be aggregated in calculating the number of shares beneficially owned by such person.

(d) Notwithstanding the provisions of paragraphs (a) and (c) of this rule:

(1)(i) A person shall be deemed to be the beneficial owner of a security, subject to the provisions of paragraph (b) of this rule, if that person has the right to acquire beneficial ownership of such security, as defined in Rule 13d-3(a) (§ 240.13d-3(a)) within sixty days, including but not limited to any right to acquire: (A) Through the exercise of any option, warrant or right; (B) through the conversion of a security; (C) pursuant to the power to revoke a trust, discretionary account, or similar arrangement; or (D) pursuant to the automatic termination of a trust, discretionary account or similar arrangement; provided, however, any person who acquires a security or power specified in paragraphs (d)(1)(i)(A), (B) or (C), of this section, with the purpose or effect of changing or influencing the control of the issuer, or in connection with or as a participant in any transaction having such purpose or effect, immediately upon such acquisition shall be deemed to be the beneficial owner of the securities which may be acquired through the exercise or conversion of such security or power. Any securities not outstanding which are subject to such options, warrants, rights or conversion privileges shall be deemed to be outstanding for the purpose of computing the percentage of outstanding securities of the class owned by such person but shall not be deemed to be outstanding for the purpose of computing the percentage of the class by any other person.

(ii) Paragraph (d)(1)(i) of this section remains applicable for the purpose of determining the obligation to file with respect to the underlying security even though the option, warrant, right or convertible

security is of a class of equity security, as defined in Rule 13d-1(i), and may therefore give rise to a separate obligation to file.

(2) A member of a national securities exchange shall not be deemed to be a beneficial owner of securities held directly or indirectly by it on behalf of another person solely because such member is the record holder of such securities and, pursuant to the rules of such exchange, may direct the vote of such securities, without instruction, on other than contested matters or matters that may affect substantially the rights or privileges of the holders of the securities to be voted, but is otherwise precluded by the rules of such exchange from voting without instruction.

(3) A person who in the ordinary course of his business is a pledgee of securities under a written pledge agreement shall not be deemed to be the beneficial owner of such pledged securities until the pledgee has taken all formal steps necessary which are required to declare a default and determines that the power to vote or to direct the vote or to dispose or to direct the disposition of such pledged securities will be exercised, provided, that:

(i) The pledgee agreement is bona fide and was not entered into with the purpose nor with the effect of changing or influencing the control of the issuer, nor in connection with any transaction having such purpose or effect, including any transaction subject to Rule 13d-3(b);

(ii) The pledgee is a person specified in Rule 13d-1(b)(1)(ii), including persons meeting the conditions set forth in paragraph (G) thereof; and

(iii) The pledgee agreement, prior to default, does not grant to the pledgee;

(A) The power to vote or to direct the vote of the pledged securities; or

(B) The power to dispose or direct the disposition of the pledged securities, other than the grant of such power(s) pursuant to a pledge agreement under which credit is extended subject to regulation T and in which the pledgee is a broker or dealer registered under section 15 of the act.

(4) A person engaged in business as an underwriter of securities who acquires securities through his participation in good faith in a firm commitment underwriting registered under the Securities Act of 1933 shall not be deemed to be the beneficial owner of such securities until the expiration of forty days after the date of such acquisition.

Rule 13d-5 -- Acquisition of securities.

(a) A person who becomes a beneficial owner of securities shall be deemed to have acquired such securities for purposes of section 13(d)(1) of the Act, whether such acquisition was through purchase or otherwise. However, executors or administrators of a decedent's estate generally will be presumed not to have acquired beneficial ownership of the securities in the decedent's estate until such time as such executors or administrators are qualified under local law to perform their duties.

(b)(1) When two or more persons agree to act together for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer, the group formed thereby shall be deemed to have acquired beneficial ownership, for purposes of Sections 13(d) and(g) of the Act, as of the date of such agreement, of all equity securities of that issuer beneficially owned by any such persons.

(2) Notwithstanding the previous paragraph, a group shall be deemed not to have acquired any equity securities beneficially owned by the other members of the group solely by virtue of their concerted actions relating to the purchase of equity securities directly from an issuer in a transaction not involving a public offering: Provided, That:

(i) All the members of the group are persons specified in Rule 13d-1(b)(1)(ii);

(ii) The purchase is in the ordinary course of each member's business and not with the purpose nor with the effect of changing or influencing control of the issuer, nor in connection with or as a participant in any transaction having such purpose or effect, including any transaction subject to Rule 13d-3(b);

This form of beneficial ownership trigger was recently upheld by the Delaware Chancery Court in *Yucaipa American Alliance Fund II, L.P. v. Riggio et al.*⁵ In *Yucaipa*, the plaintiff alleged that the Board of Barnes & Noble, Inc. breached its fiduciary duties by adopting a Rights Plan that would be triggered if a stockholder became the beneficial owner of more than 20% of Barnes & Noble's voting stock. The Rights Plan—which included a definition of “beneficial owner” that effectively restricted two or more stockholders from joining together to control the company, but did not preclude a proxy contest—was adopted in response to the plaintiff's acquisition of an 18% stake in Barnes & Noble, which the Board felt threatened the possibility

(iii) There is no agreement among, or between any members of the group to act together with respect to the issuer or its securities except for the purpose of facilitating the specific purchase involved; and

(iv) The only actions among or between any members of the group with respect to the issuer or its securities subsequent to the closing date of the non-public offering are those which are necessary to conclude ministerial matters directly related to the completion of the offer or sale of the securities.

⁴ A traditional Rights Plan definition of beneficial owner that is an expanded version of the definition of beneficial owner in Rule 13d-3 under the 1934 Act provides as follows:

(e) A Person shall be deemed the “Beneficial Owner” of, and shall be deemed to “beneficially own,” any securities:

(i) which such Person or any of such Person's Affiliates or Associates, directly or indirectly, has the right to acquire (whether such right is exercisable immediately or only after the passage of time) pursuant to any agreement, arrangement or understanding (whether or not in writing) or upon the exercise of conversion rights, exchange rights, rights, warrants or options, or otherwise; provided, however, that a Person shall not be deemed the “Beneficial Owner” of, or to “beneficially own,” (A) securities tendered pursuant to a tender or exchange offer made by such Person or any of such Person's Affiliates or Associates until such tendered securities are accepted for purchase or exchange, (B) securities issuable upon exercise of Rights at any time prior to the occurrence of a Triggering Event, or (C) securities issuable upon exercise of Rights from and after the occurrence of a Triggering Event which Rights were acquired by such Person or any such Person's Affiliates or Associates prior to the Distribution Date or pursuant to Section 2(a) or Section 17 (the “Original Rights”) or pursuant to Section 10(i) in connection with an adjustment made with respect to any Original Rights;

(ii) which such Person or any of such Person's Affiliates or Associates, directly or indirectly, has the right to vote or dispose of or has “beneficial ownership” of (as determined pursuant to Rule 13d-3 of the General Rules and Regulations under the Exchange Act), including pursuant to any agreement, arrangement or understanding, whether or not in writing; provided, however, that a Person shall not be deemed the “Beneficial Owner” of, or to “beneficially own,” any security under this subparagraph (ii) as a result of an agreement, arrangement or understanding to vote such security if such agreement, arrangement or understanding arises solely from a revocable proxy given in response to a public proxy or consent solicitation made pursuant to, and in accordance with, applicable law; or

(iii) which are beneficially owned, directly or indirectly, by any other Person (or any Affiliate or Associate thereof) with which such Person (or any of such Person's Affiliates or Associates) has any agreement, arrangement or understanding (whether or not in writing), for the purpose of acquiring, holding, voting (except pursuant to a revocable proxy as described in the proviso to subparagraph (ii) of this paragraph (e)) or disposing of any voting securities of the Company.

Some Rights Plans attempt to deal with acquisitions of derivative or synthetic securities. *See infra* notes 50-52 and related text

⁵ 1 A.3d 310, 312 (Del. Ch. 2010). *See infra* note 35.

that shareholders' would have to "relinquish control through a creeping acquisition without the benefit of receiving a control premium."⁶

⁶ *Id.* at 3. In rejecting Yucaipa's "argument that the beneficial ownership provision in the Rights Plan is ambiguous, and that the lack of clarity has unnerved Yucaipa to the point that it was chary to even discuss, much less agree to, a potential proxy slate with other Barnes & Noble investors" and thus was unreasonable. Vice Chancellor Strine commented that "the Rights Plan's trigger is based on a well-recognized standard, which sophisticated investors like Yucaipa must address as a regular course of doing business due to provisions like § 13(d) of the Securities Exchange Act of 1934 (the "Exchange Act") (§ 13D, for short), and which has been the subject of many judicial rulings including in *Moran* itself." He then summarized the negotiation of the definition as follows:

For starters, let us consider the language of Paragraph (c) of the definition of beneficial ownership in the Rights Plan, which is what Yucaipa contends is ambiguous. As originally drafted, that language provided:

A Person shall be deemed the "Beneficial Owner" of, and shall be deemed to "beneficially own," and shall be deemed to have "Beneficial Ownership" of, any securities: . . .

(c) which are beneficially owned, directly or indirectly, by any other Person (or an Affiliate or Associate thereof) with which such Person (or any of such Person's Affiliates or Associates) has (i) any agreement, arrangement or understanding (written or oral) for the purpose of acquiring, holding, voting (except pursuant to a revocable proxy as described in the proviso to clause (b)(ii) of this definition) or disposing of any voting securities of the Company or (ii) *any agreement, arrangement or understanding (written or oral) to cooperate in obtaining, changing or influencing the control of the Company.*

In response to Yucaipa's request for clarification of Paragraph (c), Cravath sent a letter to Yucaipa explaining the definition of beneficial ownership on May 11, 2010. In that letter, Cravath stated:

Pursuant to the definition of "Beneficial Owner" in the Shareholder Rights Plan, [Yucaipa] would not trigger the Shareholder Rights Plan by, among other things: (1) *mounting a proxy contest by putting forth a slate of candidates for the upcoming Board election;* (2) *putting forth any proposals for shareholder consideration that [Yucaipa] wishes;* (3) *communicating his position regarding any or other proposals to other shareholder fully and freely;* and (4) *soliciting and receiving revocable proxies in response to any public proxy solicitation made generally to all of the Company's shareholders.* Your client and his Affiliates and Associates would, however, trigger the Shareholder Rights Plan if: (1) they enter into any agreement, arrangement or understanding (written or oral) with any other shareholder for the purposes of acquiring, holding, voting (except pursuant to a revocable proxy as described above) or disposing of any voting security of the Company, or if they enter into any agreement, arrangement or understanding (written or oral) with any other shareholder to cooperate in obtaining, changing or influencing the control of the Company; and (2) the aggregate number of Shares Beneficially Owned by your client and such other shareholder and their Affiliates and Associates is 20% or more of the outstanding stock. *Thus, your client and his Affiliates and Associates would trigger the provisions of the Shareholder Rights Plan if they, along with any such shareholder, jointly share expenses of a proxy contest or propose a joint slate of directors.*

And, on June 23, 2010, the Board amended the Rights Plan to remove provision (c)(ii) from the definition of beneficial ownership entirely. As amended, Paragraph (c) is as follows:

A Person shall be deemed the "Beneficial Owner" of, and shall be deemed to "beneficially own," and shall be deemed to have "Beneficial Ownership" of, any securities: . . .

(c) which are beneficially owned, directly or indirectly, by any other Person (or an Affiliate or Associate thereof) with which such Person (or any of such Person's Affiliates or Associates) has *any agreement, arrangement or understanding (written or oral) for the purpose of acquiring,*

holding, voting (except pursuant to a revocable proxy as described in the proviso to clause (b)(ii) of this definition) or disposing of any voting securities of the Company.

In an accompanying letter to Yucaipa explaining the amendment, Cravath wrote that “[t]here can be no question now that the terms of the Rights [Plan] do not foreclose” such things as “agreeing to talk or meet about a proxy contest, participating in forums or group calls discussing the candidates or grievances of the dissident, [and] having a regional or group meeting with other investors.”

Despite the clarification provided by the letters from Cravath and by the later amendment, Yucaipa nevertheless argues that the italicized language in Paragraph (c) immediately above is still so ambiguous that it has “an *in terrorem* effect because no one can be certain what conduct might trigger the Rights Plan.” * * *

To the extent that it is based on the premise that Yucaipa is prevented from soliciting revocable proxies, Yucaipa’s argument is itself unreasonable. First, and most importantly, the Plan itself expressly carves out seeking revocable proxies in Paragraph (c). And, the letter Cravath sent to Yucaipa on May 11, 2010 lists a number of activities, including seeking revocable proxies, that Barnes & Noble views as acceptable under the Rights Plan, including:

(1) [M]ounting a proxy contest by putting forth a slate of candidates for the upcoming Board election; (2) putting forth any proposals for shareholder consideration that [Yucaipa] wishes; (3) communicating his position regarding any or other proposals to other shareholder fully and freely; and (4) soliciting and receiving revocable proxies in response to any public proxy solicitation made generally to all of the Company’s shareholders.

Thus, the Rights Plan is clear that soliciting revocable proxies is allowed, and Barnes & Noble has clarified that additional activities will not trigger the Plan. Indeed, Burkle had conversations with Eichler of Aletheia — another Schedule 13D filer — after the Rights Plan was put in place, belying any claim that he was so paralyzed by the Rights Plan that he did not dare talk to any other Barnes & Noble stockholder.

Second, as amended, the definition of beneficial ownership in Paragraph (c) is no different than the language that has been incorporated into countless rights plans since *Moran*. This court in *Moran* expressly noted the connection between the definition of beneficial ownership in the plan there and the definition under § 13D of the Exchange Act:

[The rights plan] extends the 20% triggering event to the formation of an ownership group, acting in concert for the purposes of a proxy contest. The group concept and beneficial ownership have been admittedly borrowed from comparable provisions in federal regulations under Sections 13(d) and 14(d) of the Securities Exchange Act of 1934.

Rule 13d-5, promulgated under § 13 of the Exchange Act, provides:

When two or more persons agree to act together for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer, the group formed thereby shall be deemed to have acquired beneficial ownership, for purposes of Section 13(d) and (g) of the Act, as of the date by any such persons.

Thus, like the pill in *Moran*, the Rights Plan’s definition of beneficial ownership is essentially identical in scope to Rule 13d-5. Furthermore, the definition of beneficial ownership in *Stahl* [*Stahl v. Apple Bancorp Inc.*, 1990 WL 114222 (Del. Ch. Aug. 9, 1990)] was substantively identical to the definition here. The *Stahl* rights plan provided that a shareholder is deemed to own any shares “which are beneficially owned, directly or indirectly, by any other person with which such person or any such person’s affiliates has any agreement, arrangement or understanding . . . for the purpose of acquiring, holding, voting or disposing of any securities of the [Company],” and the *Stahl* court presumed, as did the parties, that that language unambiguously circumscribed the Apple Bancorp shareholders’ ability to reach agreements regarding the joint conduct of a proxy contest.

Both *Moran* and *Stahl* also upheld those rights plans on the basis that they allowed shareholders to seek revocable proxies. Thus, because the Rights Plan here uses substantively identical language to

Flip-In and Flip Over. Once the Rights Plan is triggered, each holder of a Right (other than any Acquiring Person and certain related parties, whose Rights automatically become null and void) will have the right to receive, upon exercise, common stock having a value equal to two times the exercise price of the Right. This is known as the “*flip-in event*.” The Rights typically may not be exercised for a ten-day period following a flip-in event, during which the Company still has the ability to cause the Rights to be redeemed.

Additionally, if at any time following the date on which a person becomes an Acquiring Person:

1. The corporation is acquired in a merger or other business combination transaction in which the corporation is not the surviving corporation;
2. The corporation is acquired in a merger or other business combination transaction in which it is the surviving entity and all or part of its common stock is converted into securities of another entity, cash or other property; or
3. 50% or more of the corporation’s assets, cash flow or earning power is sold or transferred,

then each holder of a Right will have the right to receive, upon exercise, common stock of the acquiring company having a value equal to two times the exercise price of the Right. This is known as a “*flip-over*” event.

Exchange. Additionally, at any time after the Rights are triggered, Rights Plans often provide that the Board may exchange the Rights (other than Rights owned by the Acquiring Person, which will have become void), in whole or in part, at an exchange ratio of one share of common stock or an equivalent security, per Right (subject to adjustment). The exchange alternative results in less dilution than a traditional flip-in, but is a simple mechanism that can be implemented by the Board alone more quickly than a flip-in if the corporation has sufficient authorized but unissued shares. To satisfy Rights Plan requirements that the exchange shares not be issued to the Acquiring Person or its Affiliates, a trust can be formed to hold the exchange shares until ownership issues can be resolved.

Redemption. Most Rights Plans provide that the corporation may redeem Rights in whole, but not in part, at a price of \$0.01 per Right at any time prior to their being triggered. Immediately upon the action of the Board authorizing the redemption, the Rights will terminate and the only right of the holders of Rights will be to receive the redemption price.

B. Fiduciary Duties Applicable to Rights Plans.

Delaware Precedent. It is a settled principle of Delaware law that a Rights Plan, if drafted correctly, is valid as a matter of Delaware law. *See Leonard Loventhal Account v. Hilton*

the pills in *Moran* and *Stahl* and explicitly allows the solicitation of revocable proxies, there is no question that Paragraph (c) of the Rights Plan permits Yucaipa to solicit revocable proxies.

Hotels Corp.,⁷ in which the Chancery Court, citing *Moran v. Household International, Inc.*,⁸ wrote:

The Delaware courts first examined and upheld the right of a board of directors to adopt a poison pill rights plan fifteen years ago in *Moran v. Household International, Inc.* Since that decision, others have followed which affirmed the validity of a board of directors' decision to adopt a poison pill rights plan. Today, rights plans have not only become commonplace in Delaware, but there is not a single state that does not permit their adoption.

Because the adoption of a Rights Plan is likely to deter certain acquisitions, and can have the effect of entrenching directors and management, such plans are often subject to judicial scrutiny. In Delaware, the standard articulated in *Unocal Corp. v. Mesa Petroleum Co.*⁹ is still applied in evaluating shareholder Rights Plans.¹⁰ In *Unocal*, the Delaware Supreme Court held that when directors authorize takeover defensive measures, there arises “the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders.”¹¹ The Court reviewed such actions with enhanced scrutiny even though a traditional conflict of interest was absent. In refusing to enjoin a selective exchange offer adopted by the Board to respond to a hostile takeover attempt, the *Unocal* Court held that the directors must prove that (i) they had reasonable grounds for believing there was a danger to corporate policy and effectiveness (satisfied by showing good faith and reasonable investigation)¹² and (ii) the responsive action taken was “reasonable in relation to the threat posed” (established by showing that the response to the threat was not “coercive” or “preclusive” and then by demonstrating that the response was within a “range of reasonable responses” to the threat perceived).¹³

Typically, establishing that a Rights Plan is valid at the time of its adoption is no longer a major hurdle.¹⁴ Only in extreme cases will a court invalidate the traditional flip-in/flip-over structure employed by a Rights Plan.¹⁵ In fact, a Board may even have an affirmative duty to

⁷ C.A. No. 17803, 2000 WL 1528909, at *1 (Del. Ch. Oct. 10, 2000).

⁸ *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1346 (Del. 1985).

⁹ 493 A.2d 946, 949 (Del. 1985).

¹⁰ In *Yucaipa*, discussed *supra* in notes 5-6 and related text, the Court applied *Unocal* in upholding Barnes & Noble's shareholder rights plan. *Yucaipa*, 1 A.3d 310, 312 (Del. Ch. 2010).

¹¹ 493 A.2d at 954.

¹² *Id.* at 954-55.

¹³ *Id.* at 955.

¹⁴ In *Goggin v. Vermillion, Inc.*, C.A. No. 6465-VCN, 2011 Del. Ch. LEXIS 80, at *1 (Del. Ch. June 3, 2011), the Court declined to enjoin the adoption of a rights plan and advance notice bylaws where there was no evidence that the adoption of these defensive measures was motivated by entrenchment.

¹⁵ In *eBay Domestic Holdings, Inc. v. Newmark*, 16 A.3d 1, 6 (Del. Ch. 2010), the Court struck down a rights plan of a closely held corporation that was (a) designed solely to protect against a future threat to the company's corporate culture, (b) adopted in the context of several other protective (and potentially self-dealing transactions), and (c) essentially a retaliatory measure triggered by the targeted stockholder's choice to compete with the company in certain markets. By contrast, the typical Rights Plan is considered

adopt a Rights Plan where failure to do so would subject the corporation to an unfair transaction.¹⁶

The litigation concerning Rights Plans now focuses on whether or not a Board should be required to redeem the Rights in response to a particular bid. In this respect, Courts applying Delaware law have upheld, or refused to enjoin, determinations by Boards not to redeem Rights in response to two-tier offers¹⁷ or inadequate 100% cash offers¹⁸ as well as to protect an auction or permit a target to explore alternatives.¹⁹ On the other hand, some decisions have held that the Rights may not interfere with shareholder choice at the conclusion of an auction²⁰ or at the “end stage” of a target’s attempt to develop alternatives.²¹ *Grand Metropolitan Public, Ltd. v. Pillsbury Co.* involved circumstances in which the Board, rather than “just saying no,” had pursued a restructuring that was comparable to the pending all-cash tender offer.²²

Texas Precedent. In *Gearhart Industries v. Smith International* (“*Gearhart*”),²³ the United States Court of Appeals for the Fifth Circuit, applying Texas law, upheld certain defensive measures implemented by Gearhart Industries to ward off takeover attempts by Smith International. Though not a Rights Plan per se, the Gearhart Board’s response to Smith’s attempted takeover had the same basic intentions and effect: the Board authorized the issuance of subordinated debentures and warrants to purchase Gearhart common stock with so-called “springing” features, which would reduce the exercise price of the warrants by approximately

in response to an immediate threat to actual shareholder value, rather than a distant threat against an amorphous concept of “corporate culture.” See Joseph M. Grieco, *The Ever-Evolving Poison Pill: The Pill in Asset Protection and Closely-Held Corporation Cases*, 36 Del. J. Corp. L. 625 (2011).

¹⁶ *Louisiana Municipal Employees’ Retirement System v. Fertitta*, C.A. No. 4339-VCL, 2009 Del. Ch. LEXIS 144, at *30 n.34 (Del. Ch. July 28, 2009) (holding that a “board’s failure to employ a [rights plan], together with other suspect conduct, supports a reasonable inference at the motion to dismiss stage that the board breached its duty of loyalty in permitting the creeping takeover.”). See *infra* notes 53-54 and related text.

¹⁷ *Desert Partners, L.P. v. USG Corp.*, 686 F. Supp. 1289, 1290 (N.D. Ill. 1988).

¹⁸ *BNS Inc. v. Koppers Co.*, 683 F. Supp. 458, 474-75 (D. Del. 1988); *Moore Corp. v. Wallace Computer Servs., Inc.*, 907 F. Supp. 1545, 1549 (D. Del. 1995); *MAI Basic Four, Inc. v. Prime Computer, Inc.*, [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,179 (Del. Ch. 1988).

¹⁹ *CRTF Corp. v. Federated Dept. Stores, Inc.*, 683 F. Supp. 422, 438-42 (S.D.N.Y. 1988) (refusing to enjoin discriminatory application of poison pill during auction); *In re Holly Farms Corp. S’holders Litig.*, 564 A.2d 342 (Del. Ch. 1989).

²⁰ *Mills Acquisition Co. v. Macmillan, Inc.*, C.A. No. 10168, 1988 WL 108332, at *1 [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,071 (Del. Ch. 1988), *rev’d on other grounds*, 559 A.2d 1261 (Del. 1989).

²¹ *Grand Metropolitan Public, Ltd. v. Pillsbury Co.*, 558 A.2d 1049, 1050 (Del. Ch. 1988); *TW Services v. SWT Acquisition Corp.*, C.A. No. 10427, 1989 Del. Ch. LEXIS 19, at 24-25 (Mar. 2, 1989).

²² *Grand Metropolitan Public, Ltd. v. Pillsbury Co.*, 558 A.2d 1049, 1050 (Del. Ch. 1988). See *Paramount Commc’ns Inc. v. Time Inc.*, C.A. Nos. 10866, 10670, and 10935, 1989 WL 79880 at *28 (Del. Ch. July 14, 1989) [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,514, at 93,283 (Del. Ch. 1988) (in *Pillsbury* and *Interco*, management sought to “‘cram down’ a transaction that was the functional equivalent of the very leveraged ‘bust up’ transaction that management was claiming presented a threat to the corporation”), *aff’d*, 571 A.2d 1140 (Del. 1989).

²³ 741 F.2d 707, 710 (5th Cir. 1984).

25% upon the occurrence of certain events, including certain attempts to effect a change in control of Gearhart.

In a suit by Gearhart to stop Smith's takeover attempt, Smith counterclaimed that the "springing" feature of the warrants constituted a violation of Gearhart management's fiduciary duty to its shareholders because the debentures and warrants were issued primarily to entrench Gearhart's management. The Fifth Circuit stated the general rule under Texas law (Texas's version of the business judgment rule) that courts will not impose liability upon a *noninterested* corporate director unless the challenged action is *ultra vires* or is tainted by fraud.

The Fifth Circuit concluded that the question of whether the directors should be considered "interested" need not be decided because the issuance of the debentures with warrants was fair to the corporation in light of the following factors:

- (a) Gearhart's Board hired well respected financial experts and counsel to assist in the evaluation of the issuance of the debentures;
- (b) the terms of the debentures were reasonable at the time of the transaction;
- (c) the issuance and sale of the debentures were negotiated at arm's length with unaffiliated third parties; and
- (d) there were other good business reasons for issuing the debentures, such as the need to maintain corporate flexibility.

Thus, the Court in *Gearhart* did not determine whether Gearhart's directors approved the issuance of the debentures and warrants for the purpose of entrenching the existing management of Gearhart or whether such a purpose would cause the Gearhart directors to be considered "interested."

Later in *A. Copeland Enterprises, Inc. v. Guste* ("Copeland"),²⁴ the United States Federal District Court for the Western District of Texas considered the actions of the Board of Church's Fried Chicken, Inc. in adopting a shareholder Rights Plan in response to a hostile tender offer from A. Copeland Enterprises and Biscuit Investments, Inc.. The Church's Rights Plan contained "flip-in" and "flip-over" provisions which, if triggered, would immediately and severally dilute the investment of the potential acquirer.

Because the Church's Rights Plan constituted a substantial economic barrier, the tender offer was conditioned upon the invalidation or redemption of the Rights. Prior to the Court's decision, Church's announced that it would hold an "auction" to sell Church's. The Court's opinion was rendered in the context of Copeland's motion for a preliminary injunction enjoining Church's and its Board from enforcing the Rights Plan and compelling the redemption of the Rights.

²⁴ 706 F. Supp. 1283, 1285 (W.D. Tex. 1989).

The Church’s Board action in adopting the Rights Plan then was tested on whether it was consistent with the directors’ fiduciary duties, particularly the duty of loyalty. The Court in *Copeland* stated: “The duty of loyalty dictates that a director must act in good faith and must not allow his personal interests to prevail over the interests of the corporation. To prove a breach of this duty, it must be shown that the director was ‘interested.’”²⁵ The Court found that while an entrenchment motive would support a finding that directors are “interested,” it was unnecessary in that particular case to determine whether the adoption of the Rights Plan was done for the purpose of entrenchment since the plan at issue was fair to the corporation.²⁶

While the Court in *Copeland* focused on the duty of loyalty “fairness” test, and in *Gearhart* the court applied both tests separately, the two courts’ respective approaches to determining whether the transaction was “fair” seem to be in essence an application of the business judgment rule—a determination of whether any reasonable business purpose exists for the challenged actions.

While the adoption of the Church’s Rights Plan was upheld in *Copeland*, and the Court did not require that the Rights be redeemed while an auction was in progress, the Court suggested that in that case the benefits of the Rights would be gone upon completion of the auction. As discussed above, a failure to redeem Rights *after* an auction could potentially show entrenchment motives and amount to a breach of the duty of loyalty.²⁷

Redemption of the Rights Plan. Today, litigation concerning Rights Plans generally focuses on whether or not a Board should be required to *redeem* the Rights Plan in response to a particular bid. In *Copeland*, for example, the Court suggested that it would enjoin the use of the Church’s Rights Plan were it not removed at the close of an auction to facilitate a sale of the corporation to the highest bidder.²⁸ Courts applying Delaware law have upheld, or refused to enjoin, determinations by Boards not to redeem Rights in response to two-tier offers²⁹ or inadequate 100% cash offers³⁰ as well as to protect an auction or permit a target to explore alternatives.³¹ On the other hand, some decisions have held that Rights Plans may not interfere with shareholder choice at the conclusion of an auction³² or at the “end stage” of a target’s

²⁵ Id. at 1290.

²⁶ 706 F.Supp. at 1290–292.

²⁷ 706 F. Supp at 1293.

²⁸ 706 F.Supp at 1293.

²⁹ *Desert Partners, L.P. v. USG Corp.*, 686 F. Supp. 1289, 1290 (N.D. Ill. 1988).

³⁰ *BNS Inc. v. Koppers Co.*, 683 F. Supp. 458, 474-75 (D. Del. 1988); *Moore Corp. v. Wallace Computer Servs., Inc.*, 907 F. Supp. 1545, 1549 (D. Del. 1995); *MAI Basic Four, Inc. v. Prime Computer, Inc.*, [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,179 (Del. Ch. 1988).

³¹ *CRTF Corp. v. Federated Dept. Stores, Inc.*, 683 F. Supp. 422, 438-42 (S.D.N.Y. 1988) (refusing to enjoin discriminatory application of rights plan during auction); *In re Holly Farms Corp. S’holders Litig.*, 564 A.2d 342, 342 (Del. Ch. 1989).

³² *Mills Acquisition Co. v. Macmillan, Inc.*, C.A. No. 10168, 1988 WL 108332, at *1 [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,071 (Del. Ch. 1988), *rev’d on other grounds*, 559 A.2d 1261 (Del. 1989).

attempt to develop alternatives.³³ In *Yucaipa American Alliance Fund II, L.P. v. Riggio et al.*,³⁴ the Court questioned whether a Rights Plan should remain in place when a competitor “(1) won a proxy contest for a third of the seats of a classified board; (2) is not able to proceed with its tender offer for another year because the incumbent board majority will not redeem the Rights as to the offer; and (3) is required to take all the various economic risks that would come with maintaining the bid for another year.”³⁵

The fundamental question of whether or when an informed and independent Board must redeem Rights to allow an all-cash, fully financed tender offer to go forward where the Board has concluded that the offer price is inadequate was addressed in *Air Products and Chemicals, Inc. v. Airgas, Inc.*,³⁶ in which Chancellor Chandler summarized at the outset his holding that Rights did not have to be redeemed as follows:

³³ *Grand Metropolitan Public, Ltd. v. Pillsbury Co.*, 558 A.2d 1049, 1050 (Del. Ch. 1988); *TW Services v. SWT Acquisition Corp.*, C.A. No. 10427, 1989 Del. Ch. LEXIS 19, at *24-25 (Mar. 2, 1989).

³⁴ 1 A.3d 310, 351 (Del. Ch. 2010). *See supra* notes 5-6.

³⁵ The Chancery Court’s comments in *Yucaipa* were in the context of 2009, billionaire activist investor Ronald Burke’s Yucaipa American Alliance (Parallel) Fund II, L.P. (“*Yucaipa*”) rapid purchase of an 18% stake in Barnes & Noble (“*B&N*”), followed by a meeting with the chairman of B&N and largest shareholder to propose changes in its strategic direction. Yucaipa communicated in public filings that it might seek to implement changes in the company’s governance, buy additional shares in the company and propose M&A transactions. Additionally, another investment advisory firm, which had followed Yucaipa’s lead in prior investments, quickly bought another 17% of B&N. In response to the threat that B&N’s shareholders “would relinquish control through a creeping acquisition without the benefit of receiving a control premium,” the Board adopted a Rights Plan that would be triggered if a stockholder became the beneficial owner of more than 20% of B&N stock. The Rights Plan’s typical definition of “beneficial owner” effectively restricted two or more stockholders from joining together to control the company, but did not preclude a proxy contest. The Rights Plan “grandfathered in” the founder of B&N with his current 30% B&N stake, but would trigger and apply to the founder if he acquired additional shares.

In upholding the Rights Plan under the *Unocal* standard, the Chancery Court recognized that directors must demonstrate that their actions were reasonable in relation to their legitimate objective, and whether “whether the pill unreasonably restricts the ability of stockholders to run an effective proxy contest.” In this case, the Court found that “the board had a reasonable basis that Burke was potentially planning to acquire a controlling stake in B&N, or form a governing bloc with another large stakeholder.” The Court also found that the Rights Plan did not prevent an effective proxy contest by finding that the Rights Plan did not “disenfranchise any stockholder in the sense of preventing them from freely voting [nor did it] prevent a stockholder from soliciting revocable proxies.” The Court further rejected the entire fairness standard as the Board did not adopt the Rights Plan in an effort to provide a special advantage in favor of the founder of B&N, but merely grandfathered in an existing stockholder.

Yucaipa undertook, and lost, a proxy contest to elect directors who would redeem the Rights. Jeffrey A. Trachtenberg & Gina Chon, *After Winning Proxy Battle, Barnes & Noble Weighs Sale*, Wall St. J., Sept. 29, 2010, <http://online.wsj.com/article/SB10001424052748703882404575519730713498868.html>.

³⁶ *Air Products and Chemicals, Inc. v. Airgas, Inc., et al*, 16 A.3d 48, 53 (Del. Ch. 2011), in which the Delaware Supreme Court invalidated a stockholder-proposed bylaw accelerating Airgas’s annual meeting by approximately eight months, which was adopted in the context of Air Products’ takeover battle with Airgas and would have given Air Products, whose nominees had been elected to the open directorships at Airgas’s 2010 annual meeting, the opportunity to elect additional directors to Airgas’s classified board just four months later (and, conceivably, to obtain control of a majority of Airgas’s board without waiting for a full two-year meeting cycle to run). *See* Joseph M. Grieco, *The Ever-Evolving Poison Pill: The Pill in Asset Protection and Closely-Held Corporation Cases*, 36 DEL. J. CORP. L. 625 (2011).

This case poses the following fundamental question: Can a board of directors, acting in good faith and with a reasonable factual basis for its decision, when faced with a structurally non-coercive, all-cash, fully financed tender offer directed to the stockholders of the corporation, keep a poison pill in place so as to prevent the stockholders from making their own decision about whether they want to tender their shares—even after the incumbent board has lost one election contest, a full year has gone by since the offer was first made public, and the stockholders are fully informed as to the target board’s views on the inadequacy of the offer? If so, does that effectively mean that a board can “just say never” to a hostile tender offer?

The answer to the latter question is “no.” A board cannot “*just say no*” to a tender offer. Under Delaware law, it must first pass through two prongs of exacting judicial scrutiny by a judge who will evaluate the actions taken by, and the motives of, the board. Only a board of directors found to be acting in good faith, after reasonable investigation and reliance on the advice of outside advisors, which articulates and convinces the Court that a hostile tender offer poses a legitimate threat to the corporate enterprise, may address that perceived threat by blocking the tender offer and forcing the bidder to elect a board majority that supports its bid.

In essence, this case brings to the fore one of the most basic questions animating all of corporate law, which relates to the allocation of power between directors and stockholders. That is, “when, if ever, will a board’s duty to ‘the corporation and its shareholders’ require [the board] to abandon concerns for ‘long term’ values (and other constituencies) and enter a current share value maximizing mode?” More to the point, in the context of a hostile tender offer, who gets to decide when and if the corporation is for sale?

Since the Shareholder Rights Plan (more commonly known as the “poison pill”) was first conceived and throughout the development of Delaware corporate takeover jurisprudence during the twenty-five-plus years that followed, the debate over who ultimately decides whether a tender offer is adequate and should be accepted—the shareholders of the corporation or its board of directors—has raged on. Starting with *Moran v. Household International, Inc.* in 1985, when the Delaware Supreme Court first upheld the adoption of the poison pill as a valid takeover defense, through the hostile takeover years of the 1980s, and in several recent decisions of the Court of Chancery and the Delaware Supreme Court, this fundamental question has engaged practitioners, academics, and members of the judiciary, but it has yet to be confronted head on.

For the reasons much more fully described in the remainder of this Opinion, I conclude that, as Delaware law currently stands, the answer must be that the power to defeat an inadequate hostile tender offer ultimately lies with the board of directors. As such, I find that the Airgas board has met its burden under *Unocal* to articulate a legally cognizable threat (the allegedly inadequate price of Air Products’ offer, coupled with the fact that a majority of Airgas’s stockholders

would likely tender into that inadequate offer) and has taken defensive measures that fall within a range of reasonable responses proportionate to that threat. I thus rule in favor of defendants. Air Products' and the Shareholder Plaintiffs' requests for relief are denied, and all claims asserted against defendants are dismissed with prejudice.³⁷

The conduct of the Airgas Board, the Chancellor commented, "serves as a quintessential example" of the fundamental principles of Delaware law that if directors act "in good faith and in accordance with their fiduciary duties," the Delaware courts will continue to respect the Board's "reasonably exercised managerial discretion."³⁸ This principle applies when a Board acts to protect the corporation and all of its shareholders against the threat of inadequate tender offers or to protect against the special danger that arises when raiders induce large purchases of shares by arbitrageurs who are focused on a short-term trading profit rather than long-term shareholder value. The Chancellor wrote that "the power to defeat an inadequate hostile tender offer ultimately lies with the board of directors."³⁹ And it is up to the Board to decide whether a company should be sold: "a board cannot be forced into *Revlon* mode any time a hostile bidder makes a tender offer that is at a premium to market value." The Chancellor concluded: "in order to have any effectiveness, pills do not—and can not—have a set expiration date."⁴⁰

Air Products withdrew its offer for Airgas and did not appeal Chancellor Chandler's holding.⁴¹

In the end, the test is one of fairness to the corporation and its shareholders. If the Rights Plan results in negotiations with an acquirer and the proposal of a tender offer or other transaction, then the onus will be on the Board to either redeem the Rights Plan, or support a position that the proposed transaction would not be in the best interests of all shareholders.

Term and Renewal. Rights Plans expire after a specified period provided therein, which is often ten years. Renewal of a Rights Plan involves essentially the same issues as the initial adoption of a Rights Plan.

"Dead Hand" Pills. In the face of a "Just Say No" defense, the takeover tactic of choice has become a combined tender offer and solicitation of proxies or consents to replace target's Board with directors committed to redeeming the Rights Plan to permit the tender offer to proceed. Under DGCL § 228, a raider can act by written consent of a majority of the shareholders without a meeting of stockholders, unless such action is prohibited in the certificate of incorporation (under the Texas Corporate Statutes, unanimous consent is required for shareholder action by written consent unless the certificate of formation otherwise provides).⁴² Under DGCL § 211(d) a raider can call a special meeting between annual meetings only if

³⁷ *Airgas*, 16 A.3d at 54-56.

³⁸ *Id.* at 129.

³⁹ *Id.* at 55.

⁴⁰ *Id.* at 129.

⁴¹ Gina Chon, *'Poison Pill' Lives As Airgas Wins Case*, WALL ST. J., Feb. 16, 2011, at C1.

⁴² TBOC §§ 6.201, 6.202; TBCA art. 9.10(A).

permitted under the target's bylaws, whereas under the Texas Corporate Statutes any holder of at least 10% of the outstanding shares can call a special meeting unless the certificate of formation specifies a higher percentage (not to exceed 50%).⁴³ If the target has a staggered Board, a raider can generally only replace a majority of the target's board by waging a proxy fight at two consecutive annual meetings.

A target without a staggered Board cannot rely on an ordinary Rights Plan to give much protection in the face of a combined tender offer/proxy fight. The predicament faced by such targets has spawned variants of the so-called "continuing director" or "dead hand" pill.

"Pure" dead hand pills permit only directors who were in place prior to a proxy fight or consent solicitation (or new directors recommended or approved by them) to redeem the Rights Plan. Once these "continuing directors" are removed, no other director can redeem the pill.

Modified dead hand provisions come in a variety of forms. So called "nonredemption" or "no hand" provisions typically provide that no director can redeem the Rights Plan once the continuing directors no longer constitute a majority of the Board. This limitation on redemption may last for a limited period or for the remaining life of the Rights Plan. The Rights Plan at issue in the *Quickturn Design Sys., Inc. v. Shapiro* case discussed below included such a provision.

Another variant is the "limited duration," or "delayed redemption," dead hand pill. This feature can be attached to either the pure dead hand or no hand Rights Plan. As the name indicates, these pills limit a dead hand or no hand restriction's effectiveness to a set period of time, typically starting after the continuing directors no longer constitute a majority of the board. These Rights Plans delay, but do not preclude, redemption by a newly elected board.

The validity of dead hand provisions depends in large part upon the state law that applies. Delaware recently has made clear that dead hand provisions – even of limited duration – are invalid. In *Quickturn Design Sys., Inc. v. Shapiro*, the Delaware Supreme Court held that the dead hand feature of the Rights Plan ran afoul of DGCL § 141(a), which empowers the Board to manage the corporation. Relying on the requirement in DGCL § 141(a) that any limitation on the Board's power must be stated in the certificate of incorporation, the Court found that a dead hand provision would prevent a newly elected Board "from completely discharging its fundamental management duties to the corporation and its stockholders for six months" by restricting the board's power to negotiate a sale of the corporation.⁴⁴ The reasoning behind the *Quickturn* holding leaves little room for dead hand provisions of any type in Delaware.⁴⁵

⁴³ TBOC § 21.352(a)(2); TBCA art. 2.24(C).

⁴⁴ *Quickturn Design Sys., Inc. v. Shapiro*, 721 A.2d 1281, 1282 (Del. 1998), involved a "no hand" pill provision of limited duration that the target's board had adopted in the face of a combined proxy fight and tender offer by raider. The pill provision barred a newly elected board from redeeming the rights plan for six months after taking office if the purpose or effect would be to facilitate a transaction with a party that supported the new board's election. *Id.* at 1287.

⁴⁵ See also *Carmody v. Toll Bros., Inc.*, 723 A.2d 1180, 1182 (Del. Ch. 1998).

Not all states have come down against dead hand Rights Plans.⁴⁶ The Rights Plan upheld in *Copeland*⁴⁷ involved dead hand features, although the opinion did not focus on the validity of the dead hand feature.

5% NOL Rights Plans. In *Selectica, Inc. v. Versata, Inc.*,⁴⁸ the Rights Plan was designed to protect the company's net operating losses for federal tax purposes ("NOLs") and was upheld as an appropriate mechanism for protecting a company's NOLs. The Delaware Supreme Court held that lowering a Rights Plan's triggering threshold to 4.99% in order to convert a traditional Rights Plan to a NOL Rights Plan in response to a competitor's accumulation of shares is permissible under *Unocal* and its progeny as directors have broad latitude to draw reasonable conclusions about the value of a company's NOLs, the severity of the threat posed by a particular shareholder, and the appropriate defensive response under the circumstances. Finally, the Delaware Supreme Court held that even after Rights have been triggered and the acquirer diluted, a Board is permitted to implement a new Rights Plan (*i.e.*, reload) to deter further acquisitions that could jeopardize the company's NOLs.

Selectica's Rights Plan was adopted in the context of Selectica having generated \$165 million in NOLs and having rejected several acquisition offers by its competitor Trilogy, Inc. which had acquired more than 5% of Selectica's outstanding stock and continued to acquire shares. In response, the Selectica Board reviewed the effect of Trilogy's acquisitions on Selectica's NOLs and, after thorough discussion and with the advice of outside experts, determined to amend Selectica's existing Rights Plan to reduce the threshold from a typical 15% trigger to the 4.99% necessary to protect the value of Selectica's NOLs. Existing 5% shareholders were grandfathered in and permitted to acquire up to an additional 0.5% without triggering the distribution of Rights. The Board also established a committee of independent directors to review the Rights Plan periodically to ensure that it continued to be in the best interests of shareholders and to review the trigger threshold to ensure that it remained appropriate. Shortly after the adoption of this Rights Plan, Trilogy intentionally triggered Selectica's Rights Plan by increasing its stockholdings to 6.7% and refused repeated requests by Selectica to enter into a standstill agreement to give the Board time to evaluate the situation. The Selectica Board then determined to allow the exchange feature of the Rights Plan to trigger, which diluted Trilogy's holdings to 3.3%. The Board also amended the Rights Plan to reload it so that it could be triggered again if a shareholder exceeded the specified percentage of shares.

In upholding the adoption of Selectica's Rights Plan, the Supreme Court noted that rather than protecting a company from a change of control, the Selectica pill was designed to protect a corporate asset – its NOLs. The Court found that, although NOLs ultimately may be of no value to a company, the Board may, reasonably and in reliance on expert advice, conclude that the

⁴⁶ See *Invacare Corp. v. Healthdyne Tech., Inc.*, 968 F. Supp. 1578, 1578 (N.D. Ga. 1997) (rejecting the offeror's contention that a dead hand pill impermissibly restricts the power of future Boards – including a Board elected as part of a takeover bid – to redeem a rights plan, relying upon the “plain language” of a Georgia statute that expressly grants a corporation's board the “sole discretion” to determine the terms contained in a rights plan).

⁴⁷ *A. Copeland Enter., Inc. v. Guste*, 706 F. Supp. 1283, 1283 (W.D. Tex. 1989). See notes 24-25 and related text, *supra*.

⁴⁸ 5 A.3d 586, 588 (Del. Oct. 4, 2010), affirming C.A. No. 4241-VCN, 2010 WL 703062 (Feb. 26, 2010).

company's NOLs were worth protecting. This objective necessitated the low trigger threshold of 4.99%, determined by the directors with reference to tax laws and regulations. The Supreme Court observed that while a trigger under 5% may have a substantial preclusive effect, it did not constitute actual preclusion. Selectica's Rights Plan permitted the Board to redeem the Rights after an acquirer has triggered it, if the Board determines that the acquisition does not endanger the value of the NOLs. The Supreme Court, however, cautioned that the Board's actions would again be subject to judicial scrutiny if the Board were faced with a tender offer and a request to redeem the Rights and that, citing *Moran*, a "Board has no more discretion in refusing to redeem the Rights Plan than it does in enacting any other defensive mechanism."⁴⁹

Derivative Positions. *In re Atmel Corp. S'holders Litig.*⁵⁰ involved an application for an injunction (which the Court of Chancery denied) through which the plaintiff sought to invalidate an amendment to Atmel corporation's stockholder Rights Plan that included certain derivative positions in calculating a stockholder's total beneficial ownership for purposes of determining whether the stockholder had triggered the Rights Plan. During the course of rejecting an all-cash tender to acquire Atmel, the Atmel Board publicly rejected the offer as not in the stockholders' best interests and thereafter adopted an amendment to Atmel's Rights Plan (i) lowering the percentage of equity ownership necessary to trigger the Rights Plan from 20% to 10%, and (ii) expanding the definition of "beneficial ownership" to include derivative contracts that are designed to produce economic benefits and risks that correspond substantially to ownership of Atmel common shares.⁵¹

⁴⁹ *Selectica*, 5 A.3d at 607.

⁵⁰ C.A. No. 4161-CC (Del. Ch. May 19, 2009).

⁵¹ The Court in *Atmel* described the amendment to Atmel's Rights Plan as follows:

On November 10, 2008, in response to these advances, the Atmel board adopted an amendment to Atmel's rights plan. The amendment has two principal features. First, it lowers the percentage of equity ownership necessary to trigger the rights under the plan from 20 percent to 10 percent for any person or group of persons that made a takeover proposal or made a "takeover proposal" on or after October 1, 2008.

Second, it expands the definition of Beneficial Ownership to encompass derivatives contracts that are designed to produce economic benefits and risks that correspond substantially to the ownership of Atmel common shares. The amended definition of "beneficial ownership" provides, in part, that a person shall be deemed to beneficially own any securities "which are beneficially owned, directly or indirectly, by a Counterparty under any derivatives contract to which such person or any of such person's affiliates or associates is a receiving party."

The definition also provides that "the number of common shares that a person is deemed to own beneficially in connection with a particular derivatives contract shall not exceed the number of notional common shares that are subject to such derivatives contract."

The definition further provides that "the number of securities beneficially owned by each Counterparty, (Counterparty A) under a derivatives contract shall be deemed to include all securities that are beneficially owned, directly or indirectly, by a Counterparty, (Counterparty B) under any derivatives contract to which such Counterparty A is a receiving party, with this proviso being applied to successive Counterparties as appropriate.

The amendment defines a "derivatives contract" as "a contract between two parties, (the receiving party and the Counterparty) that is designed to produce economic benefits and risks to the receiving party that correspond substantially to the ownership by the receiving party of a number of common

The plaintiff in *Atmel* claimed that the amendment was so indefinite and uncertain in its terms that there was no objective means of determining how the Rights Plan operated or when it is triggered, and thus was invalid because its adoption constituted a *per se* breach of fiduciary duty or an *ultra vires* act. The plaintiff argued that (i) stockholders may be unable to determine the extent of their beneficial ownership under the expanded definition of “beneficial ownership” because a stockholder is imputed with ownership of not only the shares owned by its counterparty, but also those shares owned by its counterparty’s counterparties; (ii) it would be impossible for Atmel to sort through the various layers of counterparties to determine beneficial ownership of a stockholder; and (iii) the definition of “derivatives contract,” which provided that a contract “designed to produce economic benefits and risks to the receiving party that correspond substantially to the ownership by the receiving party of a number of common shares” (regardless of whether the contract was settled through cash or other property) was so vague as to include interests in mutual funds with a large percentage of their holdings represented by Atmel stock because such funds “may well substantially correspond to the economic risks and benefits” of owning Atmel stock. The Court denied the plaintiff’s motion for injunctive relief because the plaintiff had failed to carry its burden to show a reasonable probability of success on the merits as had been presented only with abstract and theoretical legal arguments based on hypothetical scenarios.

The *Atmel* case was ultimately settled pursuant to a settlement agreement⁵² which provided that if prior to September 14, 2012, Atmel adopts a new Rights Plan that includes a “Derivative Contract” within the definition of “Beneficial Ownership,” Atmel will clarify that (i) the term “Derivatives Contract” excludes interests in broad-based index options, broad-based index futures, and broad-based publicly traded market baskets of stock approved for trading by the appropriate federal governmental authority; and (ii) to qualify as or constitute a “Derivatives Contract,” a contractual arrangement must include or reference a number of “Notional Common Shares.” The Atmel Board also passed a resolution interpreting its definition of “Beneficial Ownership” in its existing Rights Plan consistent with the foregoing.

Duty to Adopt Rights Plan. In two recent cases the Delaware Court of Chancery has suggested that a special committee formed to negotiate with a controlling stockholder should be given by the Board the power to adopt a Rights Plan to prevent the controlling stockholder from dominating the process, and that the failure to do so may suggest that the Board has not handled the process in accordance with its fiduciary duties. *In re CNX Gas Corp. Shareholders Litigation*,⁵³ involved a special committee formed to negotiate a freeze two-step merger in which the controlling stockholder would make a tender offer followed by a short-form merger, and the Court noted that the special committee had been deprived of the negotiating leverage that comes from the ability to adopt a Rights Plan, commenting that “[t]he shadow of pill adoption alone

shares regardless of whether obligations under such contract are settled through the delivery of cash, common shares or other property, without regard to any short position under the same or any other derivative contract.”

⁵² Stipulation and Agreement of Compromise, Settlement and Release dated November 6, 2009, available at http://google.brand.edgar-online.com/EFX_dll/EDGARpro.dll?FetchFilingHtmlSection1?SectionID=6899365-7014-122449&SessionID=zRoyHqfwJUKJbs7.

⁵³ C.A. No. 5377-VCL, 2010 Del. Ch. LEXIS 139, at *1 (Del. Ch. July 5, 2010).

may be sufficient to prompt a controller to give a special committee more time to negotiate or to evaluate how to proceed.” In *Louisiana Municipal Employees’ Retirement System v. Fertitta*,⁵⁴ the Chancery Court suggested that there may be a Board duty to adopt a Rights Plan where failure to do so would subject the corporation to an unfair transaction with a controlling stockholder.

⁵⁴ C.A. No. 4339-VCL, 2009 Del. Ch. LEXIS 144, at *2 (Del. Ch. July 28, 2009).