CHOICE OF ENTITY DECISION TREE

By

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Involvement: Mr. Egan is Senior Vice Chair and Chair of Executive Council of the ABA M&A Committee 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; 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. He is the author of the treatise *EGAN ON ENTITIES: Corporations, Partnerships and Limited Liability Companies in Texas* (May 2016). In addition, 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 twenty 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. A four-time winner of the Burton Award for Legal Achievement, 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 and Who's Who Legal. See www.jw.com for additional information regarding his civic and other activities.

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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")[1]

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

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The author wishes to particularly acknowledge the contributions of William H. Hornberger and Miles R. McDougal of Jackson Walker L.L.P in Dallas in preparing Appendix A – Federal Taxation of Entities, and Steven D. Moore of Jackson Walker L.L.P. in Austin in preparing Appendix B – Texas Margin Tax. The contributions of the following are also acknowledged: Michael L. Laussade and David D. Player of Jackson Walker L.L.P. in Dallas.

[1] *See generally* BYRON F. EGAN, EGAN ON ENTITIES: Corporations, Partnerships and Limited Liability Companies in Texas (May 2016), which contains substantially more information on the subjects treated in this paper. For information as to how to purchase EGAN ON ENTITIES: Corporations, Partnerships and Limited Liability Companies in Texas (May 2016), contact the author at began@jw.com.

requirements.[2] The Texas LLP statute was later amended to extend its LLP shield to contracts. 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,[3] and the LLC has become the entity of choice for private deals.[4]

The Texas Legislature enacted the Texas Business Organizations Code (the "TBOC")[5] 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,[6] although they could elect to be governed by the TBOC prior to that time.[7]

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"),[8] the Delaware Revised Uniform Partnership Act ("DRPA"),[9] the Delaware Revised Limited Partnership Act ("DRLPA),[10] and the Delaware Limited Liability Company Act (the "DLLCA").[11]

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

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

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

4 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.

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

6 TBOC § 402.005.

7 TBOC § 402.003.

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

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

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

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

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.[12] 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. 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.[13] 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."[14] 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 2016 is 0.75% for all taxpayers except a narrowly defined group of retail and wholesale businesses which pay a 0.375% rate.[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, with the result that now substantially more LLCs are being formed in Texas and Delaware than any other form of entity, but the uncertainties as to an LLC's treatment for self-employment purposes continue to restrict its desirability in some situations.[16]

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12 *See* Appendix A – Federal Taxation of Entities.

13 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 SND List and OFAC guidance are available on the OFAC website at http://www.ustreas.gov/offices/enforcement/ofac/.

14 *See* Appendix B – Texas Margin Tax.

15 *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).

16 *See* Appendix A – Federal Taxation of Entities.

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 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]

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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*, 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 TBOC was amended in 2015 Legislative Session by two bills supported by the Texas Business Law Foundation:

S.B. 860 by Sen. Kevin Eltife (*available at* http://www.capitol.state.tx.us/BillLookup/History.aspx?LegSess=84R&Bill=SB860) amended the TBOC to update its provisions relating to corporations, including *inter alia*,

- replaced the statutory prohibition against a domestic entity's merger or conversion (and against a plan of exchange being effected) if it results in personal liability for an owner or member of that entity without the owner's or member's consent with a simple prohibition on the owner or member becoming subject to "owner liability" without the owner's or member's consent, and then defining "owner liability" as personal liability for a liability or other obligation of an entity that is imposed on a person by statute solely because of the person's status as an owner or member of the entity or by a governing document thereof under the TBOC or law of the entity's jurisdiction of formation;
- provided that ownership interests are not required to be certificated to the extent a governing document of the entity or a resolution adopted by the entity's governing authority provides that some or all of the classes or series of the ownership interests are uncertificated or provides that some or all of each of the classes or series of the ownership interests are uncertificated and clarifying that an entity may have outstanding both certificated and uncertificated ownership interests of the same class or series;
- required a plan of merger to include, among other required information, the identification of any of the ownership or membership interests of an entity that is a party to the merger that are to remain outstanding rather than converted or exchanged if the entity survives the merger;
- authorized any of the terms of a plan of merger, exchange, or conversion to be made dependent on facts ascertainable outside of the plan, as applicable, if the manner in which those facts will operate on the terms thereof is clearly and expressly stated in the plan;
- authorized a plan of merger to include amendments and restatements of the governing documents of any surviving entity;
- required any limit on the term or duration of a corporation's shareholders' agreement to be set forth in the agreement, removes a provision establishing the validity of such a shareholders' agreement for a period of 10 years, and establishes that a shareholders'

agreement that was in effect before September 1, 2015, remains in effect for 10 years, unless the agreement provides otherwise;

- authorized the amount of the consideration to be received for shares to be determined by the Board, or plan of merger or conversion, as applicable, by means of approval of a formula to determine that amount;
- authorized bylaws to require one or both of the following (i) when soliciting proxies or consents with respect to an election of directors, the corporation include in both its proxy statement and any form of its proxy or consent one or more individuals nominated by a shareholder in addition to individuals nominated by the Board; or (ii) the corporation reimburse expenses incurred by a shareholder in soliciting proxies or consents with respect to an election of directors so long as the reimbursement requirement does not apply to any election for which the record date precedes that requirement's adoption;
- based on DGCL § 251(h), amended TBOC § 21.459 to permit a plan of merger for a public company to contain provisions obviating need for a shareholder vote on the merger, after acquiring in a tender offer sufficient shares to approve the merger and provides dissenters rights in such a merger;
- based on DGCL §§ 204 and 205, added TBOC §§ 21.901-21.917 providing statutory procedures to the ratification of defective corporate acts or shares, including establishes that a defective corporate act or putative shares is not void or voidable solely as a result of a failure of authorization if the act or shares are ratified in accordance with these TBOC provisions or validated by a district court.

S.B. 859 by Sen. Kevin Eltife (*available at* http://www.capitol.state.tx.us/BillLookup/History.aspx?LegSess=84R&Bill=SB859) to updated TBOC provisions relating to partnerships and limited liability companies, including , *inter alia*,

- specified that an application for registration of an LLP accepted by the Secretary of State is considered to be an effective registration and conclusive evidence of the satisfaction of all conditions precedent to an effective LLP registration;
- provided that an LLP registration is effective until it is withdrawn or terminated and repeals the annual renewal requirements;
- established that an LLP registration, except in a proceeding by the State to terminate its registration, continues in effect so long as there has been substantial compliance with statutory provisions relating to the registration generally and with annual reporting requirements established by the bill's provisions, effective January 1, 2016;
- required an LLP that has an effective registration, not later than June 1 of each year following the calendar year in which the application for LLP registration takes effect, to file with the Secretary of State a report that contains the name of the LLP and the number of its partners as of the date of filing of the report;
- required the Secretary of State, not later than March 31 of each year, to provide to each LLP that had an effective registration as of December 31 of the preceding year a written notice stating that the annual report and applicable filing fee are due on June 1 of that year and the registration of the LLP will be terminated unless the report is filed and the filing fee is paid on or before the date prescribed;
- required the Secretary of State to impose a fee for filing the annual report in an amount equal to $200 for each partner on the date of filing the report;
- established that the registration of an LLP that fails to timely file an annual report or pay the required filing fee is automatically terminated;
- specified that the termination of an LLP registration affects only the LLP's status as an LLP and is not an event requiring a winding up and termination of the partnership;

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] 2011[24] and 2013.[25] The TBOC is still a work in

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- authorized an LLP whose registration was terminated for failure to file the annual report or pay the filing fee to apply to the Secretary of State for reinstatement of its LLP status not later than the third anniversary of the effective date of the termination;
- for the purposes of LLC or partnership formation, internal affairs or termination, a power of attorney is irrevocable if the power of attorney is coupled with an interest sufficient in law to support an irrevocable power and the power of attorney states that it is irrevocable, and that the irrevocable power of attorney, unless otherwise provided in the power of attorney, is not affected by the subsequent death, disability, incapacity, winding up, dissolution, termination of existence, or bankruptcy of, or any other event concerning, the principal;
- excluded the term "majority-in-interest," as defined in statutory provisions relating to supplemental provisions for domestic general partnerships, from a provision prohibiting a partnership agreement or the partners from waiving or modifying certain general provisions of the TBOC;
- created an exception to the requirement that a general partner file a certificate of amendment reflecting a change in the address of the registered office or a change in the name or address of the registered agent of the limited partnership if the registered agent of a filing entity or foreign filing entity files the required statement of such change in accordance with statutory provisions related to the filing; and
- repealed a statutory provision limiting the applicability of statutory provisions relating to meetings of and voting by LLCs to the governing authority of an LLC.

In addition to the TBOC amendments described above, S.B. 1077 by Sen. Kevin Eltife amended Section 1.201(b)(27) of the Texas Business & Commerce Code to expand the definition of "person" under the Uniform Commercial Code to include a particular series of a for-profit entity, although LLC series are defined in TBOC §101.622 as not being separate from their connected limited liability companies, although a series is authorized to function separately for certain purposes (*available at* http://www.capitol.state.tx.us/BillLookup/History.aspx?LegSess=84R&Bill=SB1077).

See 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").

[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.
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> 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.
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> 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.
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> 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.

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 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

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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

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.

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, 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.

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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").

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.

(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 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

46 TBOC § 1.002(35).

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.

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 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]

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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.

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.

(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 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 Act[78] 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).

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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.

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).

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 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]

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

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

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

86 *See* TBOC § 10.251; TBCA arts. 5.09 and 5.10. *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

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

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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 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).

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 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

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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.

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 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

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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, no pet.), 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).

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]

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]

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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).

96 TBOC § 10.008(a)(4) 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

1.4.4. Conversions.

(a) General. Texas law allows Texas corporations, LLCs and partnerships to convert from one form of entity into another form of entity, domestic or foreign, 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

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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 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 TBOC Chapter 10, Subchapter C; TBCA Part Five; *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). In the case of the conversion of a Texas entity into a foreign entity, TBOC § 10.102 requires that the conversion be permitted by, and effected in accordance with, the laws governing the foreign entity.

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

its source Texas entity statutes each have provisions relating to the mechanics of adopting a plan of conversion, obtaining owner approval, 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]

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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.

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

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

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

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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 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."

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]

(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

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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 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*, 369 S.W.3d 301, 319 (Tex. App.—Houston [1st Dist.] 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 combination of such entities and arrangements.[111] Structure decisions for a particular joint 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.[114] 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").[115]

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 discussion in Appendix A; (3) a Texas Margin Tax discussion 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

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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).

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 *See infra* notes 727-731 and related text.

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

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

Prior to January 1, 2006, Texas business corporations were organized under the TBCA.[116] 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.[117]

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."[118] 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,[119] 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").[120] 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).[121] Texas has similar statutory authority from TBOC § 21.057 which states: "The bylaws may contain provisions for the regulation and management of the

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116 TBCA arts. 1.01 *et. seq.*

117 *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).

118 TBOC § 1.008(b).

119 TBOC §§ 3.001-3.008; DGCL § 101.

120 DGCL § 101

121 DGCL § 109.

affairs of the corporation that are consistent with law and *the corporation's certificate of formation*" (emphasis added).[122]

(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.[123]

(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.[124] If directors were named, then they can amend the Charter by majority vote.[125] 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).[126] 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.[127] 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.[128]

(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.[129] If a corporation has outstanding and issued shares, however, the resolution passed by the directors must include a

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122 TBOC § 21.057(b).

123 TBOC §§ 3.001-3.008; DGCL § 101.

124 DGCL § 241.

125 *Id.*

126 DGCL § 242.

127 *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."

128 DGCL § 228.

129 TBOC § 21.053.

provision to submit the amendment to a shareholder vote and then the shareholders must approve the amendment.[130] 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.[131] 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 would be necessary under the Charter to approve the action.[132] After the requisite approvals, the Charter is amended by filing a certificate of amendment with the Texas Secretary of State.[133]

(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.[134] 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.[135] DGCL § 102(b) provides for permissive inclusion of certain provisions in 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.

(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

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130 TBOC § 21.054.

131 TBOC § 21.055.

132 TBOC §§ 6.201 and 6.202.

133 TBOC §§ 3.052-3.054.

134 DGCL § 102(a).

135 *Id.*

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 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

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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.

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.

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 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.

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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.

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 § 21.361

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 TBOC §§ 21.152-21.157.

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]

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.[155] Each also provides that both the Board and the shareholders have the power to adopt, amend or repeal the corporation's bylaws.[156]

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152 TBOC §§ 21.157 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 § 21.401; TBCA art. 2.31; DGCL § 141(a). *See supra* notes 202 and 203 and related text.

156 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 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

In Texas, after the Secretary of State officially acknowledges the filing of the corporation's certificate of formation,[157] 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.[158] 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.[159] 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.[160] In the absence of a contrary provision in the corporation's governing document, the TBOC, bylaws may be adopted or amended orally or by acts evidenced by a uniform course of proceeding or usage and acquiescence.[161]

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").[162] 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.[163]

(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.[164] Further, if after adopting a resolution approving a merger the Board determines that the plan of merger is not

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whether the bylaws may also be amended, repealed, or adopted by the corporation's board of directors.

157 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.

158 TBOC § 21.059; TBCA art. 3.06.

159 TBOC § 21.057; TBCA art. 2.33A.

160 TBOC § 21.058; TBCA art. 2.23.

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

162 *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).

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

164 TBOC § 21.452(d).

advisable, the plan of merger may be submitted to the shareholders with a recommendation that the shareholders not approve the plan[165] A plan of merger may contain a provision requiring that it be submitted for shareholder vote regardless of whether the Board subsequently changes its recommendation and recommends that the shareholders vote against approving the plan of merger.[166] The TBOC permits shareholder action on a merger by unanimous written consent[167] or, if the certificate of incorporation so provides, by the shareholders having the minimum number of shares required to approve the merger.[168] 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.[169] 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.[170]

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.[171] Delaware law provides that mergers may be approved by a vote of the holders of a majority of the outstanding shares.[172] 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.[173]

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

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165 TBOC § 21.452(f).

166 TBOC § 21.452(g).

167 TBOC § 6.201.

168 TBOC § 6.202.

169 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).

170 TBOC § 21.365(a); TBCA art. 2.28.

171 *See* DGCL § 251(b), (c) (2013).

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

173 DGCL § 146.

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 stockholders.[174] 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.

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.[175] Directors are legally constrained from engaging in "contractual attempts to circumscribe [their] ability . . . to fulfill their fiduciary duties."[176] As a result, merger agreements often contain a change of recommendation provision that allows the Board to change its recommendation that stockholders 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.[177]

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.[178] 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

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[174] 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.

[175] *See Frontier Oil Corp. v. Holly Corp.*, C.A. No. 20502-VCN, 2005 WL 1039027, at *27 (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).

[176] *Energy Partners, Ltd. v. Stone Energy Corp.*, C.A. Nos. 2374-N, 2402-N, 2006 Del. Ch. LEXIS 182 at *64 n. 144 (Del. Ch. Oct. 11, 2006).

[177] *See infra* note 442.

[178] *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).

creation of an "entity" separate and distinct from the individual shareholders.[179] 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*,[180] 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.[181]

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

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179 *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, 836 (Tex. Civ. App.—San Antonio 1966, writ ref'd n.r.e.).

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

181 *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 & 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.

offices and employees, keeping separate books, holding regular meetings of shareholders and board of directors, keeping written minutes of such meetings, etc.).[182] 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.[183]

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.*[184] 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.[185] *SSP* rejects the single

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182 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.).

183 *Southern Union Co. v. City of Edinburg*, 129 S.W.3d 74, 87 (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, 169, 174 (Tex. App.—San Antonio 1998 no pet.) (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 pet. stricken) (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, 429-430 (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 at *4 (Tex. App.—Houston [1st Dist.] Aug. 29, 2003 no pet.) (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).

184 275 S.W.3d 444 (Tex. 2008).

185 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 <u>sharing of names, offices, accounting, employees, services, and finances</u>. There is <u>nothing abusive or unjust about any of these</u> practices in the abstract. <u>Different entities may coordinate their activities without joint liability</u>.

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 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.[186]

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.[187] There are causes of action for holding an officer personally liable for the officer's

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> 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.
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> * * *
>
> 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]
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> * * *
>
> 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).

186 *See Tryco Enter., Inc. v. Robinson*, 390 S.W.3d 497 (Tex. App.—Houston [1st Dist.] 2012), pet. dism'd); No. 12-0866, 2013 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).

187 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

own wrongful conduct,[188] for an individual is liable for his own torts although a corporation may assume the liability pursuant to an indemnification arrangement.[189]

Controlling shareholders can have liability for actions of a controlled corporation under federal and state securities laws,[190] laws for the protection of the environment,[191] employment laws[192] and other federal and state statutes specific to the activities of the corporation.

2.5. <u>Management</u>. The corporation form of business entity allows for an efficient and flexible management structure. The traditional management structure of a corporation is centralized.[193] Shareholders elect directors, who are given the power to manage the affairs of the corporation generally, as well as to formulate policies and objectives.[194] Shareholders retain the

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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).

[188] 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.

[189] *See* TBOC §§ 8.001 et seq.

[190] Securities Act of 1933 § 15, Securities Exchange Act of 1934 § 20, and Texas Securities Act §§ 33.F and 33-1.E; *cf. infra* notes 995-998, and related text.

[191] *See* Byron F. Egan, Lindsay T. Boyd, Jon T. Hirschoff, 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).

[192] *See Guippone 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 "<u>WARN Act</u>") for failure of controlled portfolio company to provide the requisite sixty days' advance notice of mass layoffs or plant closings to employees).

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

[194] *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.

power to vote on certain major matters.[195] Directors appoint officers, who are delegated the 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 TBOC and the Delaware General Corporation Law (the "DGCL"), also provide for "close corporations" which may be managed by the shareholders directly.[196] 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

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195 TBOC § 21.358 and TBCA art. 2.28 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. TBOC § 21.359; TBCA art. 2.28. 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. TBOC § 21.364; TBCA arts. 4.02A(3), 5.03E and 6.03A(3). 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. TBOC § 21.365(a); TBCA art. 2.28(D).

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. TBOC § 21.363; TBCA art. 2.28(B).

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. TBOC §§ 21.360, 21.362; TBCA art. 2.29(D).

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

The voting of shares by proxy is permitted. TBOC § 21.367(a) ; TBCA art. 2.29. 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. TBOC §§ 21.367(b), 21.369(b) ; TBCA art. 2.29(C).

TBOC Chapter 3F, as added in the 2009 Legislative Session by 2009 S.B. 1442 § 4, provides than 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.

196 *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).

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.[197] 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.[198] Thus,

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

198 TBOC § 21.101, like its predecessor TBCA art. 2.30-1, in effect extends close corporation flexibility to all corporations that are not publicly traded by authorizing shareholders' agreements that modify and override the mandatory provisions of the TBOC or the TBCA relating to operations and corporate governance. The agreement must be set forth in either (i) the articles of incorporation or bylaws and approved by <u>all</u> shareholders or (ii) in an agreement signed by <u>all</u> shareholders and made known to the corporation. TBOC § 21.101(b); TBCA art. 2.30-1(B)(1). The agreement is not required to be filed with the Secretary of State unless it is part of the articles of incorporation. TBOC §§ 21.101(b), 4.002; TBCA arts. 2.30-1(B), 3.03. 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 TBOC § 21.303 (or TBCA art. 2.38, 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;

(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 TBOC §§ 21.501-21.504 or TBCA art. 6.02; 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.

TBOC § 21.101(a); TBCA art. 2.30-1(A). The existence of a TBOC § 21.101 or TBCA art. 2.30-1 agreement must be conspicuously noted on the certificates representing the shares or on the information statement required for uncertificated shares. TBOC §§ 21.103(a), (b); TBCA art. 2.30-1(C). 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. TBOC § 21.105; TBCA art. 2.30-1(D). An agreement permitted under TBOC § 21.101 or TBCA art. 2.30-1 will cease to be effective when shares of the corporation become listed on a national securities exchange, the management structure of corporations is generally flexible enough to 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.[199] Fiduciary duty principles articulated in the context of public companies are applicable to private companies in both Texas and Delaware, although the application of those principles is contextual and the corporate process required to comply with those principles can vary depending on the circumstances.[200]

Both the Tex. Corp. Stats. and the Delaware General Corporation Law (as amended, the "DGCL")[201] provide that the business and affairs of a corporation are to be managed under the

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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. TBOC § 21.109; TBCA art. 2.30-1(E).

A TBOC § 21.101 or a TBAC art. 2.30-1 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 TBOC, the TBCA, or other law on directors to the extent that the discretion or powers of the directors are limited or supplanted by the agreement.

TBOC § 21.107 and TBCA art. 2.30-1(G) provide that the existence or performance of a shareholders 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, TBOC § 21.107 and TBCA art. 2.30-1 provide protection beyond TBOC § 21.223 and TBCA art. 2.21 on shareholder liability.

199 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, 477-478 (1979). Federal courts generally apply applicable state common law in fiduciary duty cases. *See e.g. Floyd v. Hefner*, C.A. No. H-03-5693, 2006 WL 2844245, at *8-9 (S.D. Tex. Sept. 29, 2006).

200 Under TBOC § 21.563(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) *reh'g denied* (Oct. 24, 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 599-643 regarding oppression of minority shareholders in the context of closely held entities.

201 DGCL § 101 *et seq.* (Supp. 2015).

direction of its board of directors ("Board").[202] 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.[203] In Texas, the fiduciary duty of a director has been

[202] 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).

[203] 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. Dec. 13, 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, 2007 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. *Id.*

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. *Id.* at *1-2. 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 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 characterized as including duties of loyalty (including good faith), care and obedience,[204] and is owed to the corporation and its shareholders collectively.[205] In Delaware, the fiduciary duties include those of loyalty (including good faith) and care.[206] 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.[207] The term "duty of disclosure," however, is somewhat of a misnomer because no separate <u>duty</u> of disclosure actually exists. Rather, as indicated, the fiduciary obligations of

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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. *Id.*

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. 2014) (holding that Board action by deception is voidable, not void *ab initio*).

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

205 *Ritchie v. Rupe*, 443 S.W.3d 856, 883 (Tex. 2014), *reh'g denied* (Oct. 24, 2014) ("[t]he directors must make those decisions in compliance with the formal fiduciary duties that they, as officers or directors, owe to the corporation, *and thus to the shareholders collectively*" (emphasis added)); *Redmon v. Griffith*, 202 S.W.3d 225, 233 (Tex. App.—Tyler 2006, pet. denied), *disapproved of by Ritchie v. Rupe*, 443 S.W.3d 856 (Tex. 2014) ("[t]raditionally, *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" (emphasis added)).

206 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.

Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006).

207 "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.").

directors with respect to the disclosures involve a contextually-specific application of the duty of loyalty.[208]

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,"[209] and "under the commerce clause a state has no interest in regulating the internal affairs of foreign corporations."[210] "Internal corporate affairs" are "those matters which are peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders,"[211] and are to be distinguished from matters which are not unique to corporations.[212]

Under the internal affairs doctrine followed by Texas and most other states, the law of the state of organization of an entity governs its internal affairs,[213] including the liability of an owner or governing person of the entity for actions taken in that capacity.[214] Thus, 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.[215] Delaware also subscribes to the internal affairs doctrine.[216]

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208 *Malone v. Brincat*, 722 A.2d 5, 10 (Del. 1998) ("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 honestly. * * * The duty of disclosure obligates directors to provide the stockholders with accurate and complete information material to a transaction or other corporate event that is being presented to them for action."); *Jackson Nat'l Life Ins. Co. v. Kennedy*, 741 A.2d 377, 390 (Del. Ch. 1999) ("[W]hen directors communicate with stockholders, they must recognize their duty of loyalty to do so with honesty and fairness, regardless of the stockholders' status as preferred or common, and regardless of the absence of a request for action required pursuant to a statute, the corporation's certificate of incorporation or any bylaw provision.").

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

210 *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).

211 *McDermott*, 531 A.2d at 214.

212 *McDermott*, 531 A.2d at 214-215 (citing *Edgar*, 457 U.S. at 645).

213 The internal affairs doctrine is codified in TBOC §§ 1.101-1.105 (2015). TBOC § 1.105 provides:

> Sec. 1.105. INTERNAL AFFAIRS. For purposes of this code, the internal affairs of an entity include:
>
> (1) the rights, powers, and duties of its governing authority, governing persons, officers, owners, and members; and
>
> (2) matters relating to its membership or ownership interests.

214 TBOC § 1.104.

215 *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).

216 *See VantagePoint Venture Partners 1996 v. Examen, Inc.*, 871 A.2d 1108, 1115-1118 (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,

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.[217] Texas does not have a comparable statute.

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.[218]

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.[219] 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.[220]

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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 387-397 and related text.

217 10 Del. C. § 3114(a) and (b).

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

219 *Id.* at 719-21; *McCollum 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*).

220 *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.)

The Texas Supreme Court's June 20, 2014 opinion in *Ritchie v. Rupe*[221] 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 itself[222] – 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 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).[223]

In Texas there are two types of fiduciary relationships out of which fiduciary duties arise.[224] The first is a <u>formal</u> fiduciary relationship, which arises as a matter of law.[225] The second is an <u>informal</u> fiduciary relationship, which may arise from a moral, social, domestic or purely personal relationship of trust and confidence, generally called a confidential relationship.[226]

Whether undisputed facts give rise to a <u>formal</u> fiduciary relationship is a question of law.[227] Whether an <u>informal</u> fiduciary relationship exists is ordinarily a question of fact because the underlying material facts are disputed.[228] When the underlying facts are undisputed,

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221 443 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*).

222 *See infra* notes 597-639 regarding oppression of minority shareholders in the context of closely held entities.

223 443 S.W.3d at 868.

224 *Meyer v. Cathey*, 167 S.W.3d 327, 330–31 (Tex. 2005); *Chapman Children's Trust v. Porter & Hedges, L.L.P.*, 32 S.W.3d 429, 439 (Tex. App.—Houston [14th Dist.] 2000, pet. denied).

225 *Abetter Trucking Co., Inc. v. Arizpe*, 113 S.W.3d 503, 508 (Tex. App.—Houston [1st Dist.] 2003, no pet.) (citing *Ins. Co. of N. Am. v. Morris*, 981 S.W.2d 667, 674 (Tex.1998)).

226 *Id.* (quoting *Assoc. Indem. Corp. v. CAT Contracting, Inc.*, 964 S.W.2d 276, 287 (Tex. 1998)); *see supra* notes 275-279 and related text.

227 *Envtl. Procedures, Inc. v. Guidry*, 282 S.W.3d 602, 627 (Tex. App.—Houston [14th Dist.] 2009, pet. denied).

228 *Hoggett v. Brown*, 971 S.W.2d 472, 488 (Tex. App.—Houston [14th Dist.] 1997, pet. denied).

however, the determination of whether a fiduciary relationship exists is a question of law for the court.[229]

Controlling shareholders generally do not owe formal fiduciary duties to minority shareholders. In *Ritchie v. Rupe*, the Supreme Court stated: "this Court has never recognized a formal fiduciary duty between majority and minority shareholders in a closely held corporation."[230] In certain circumstances, an officer or director of a closely-held company "may become" a fiduciary to individual shareholders when the corporation repurchases the shareholder's stock.[231] A controlling shareholder may owe informal fiduciary duties to the minority shareholders.[232] Since Texas courts generally do not distinguish between publicly held and closely held corporations, these principles should apply equally to Texas corporations whose shares are publicly traded.

(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.[233] Whether there exists a personal interest by the director will be a question of fact.[234] The good faith of a director will be determined on whether the director acted with an intent to confer a benefit to the corporation.[235] 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."[236]

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229 *Meyer v. Cathey*, 167 S.W.3d 327, 330 (Tex. 2005).

230 443 S.W. 3d 874-875 note 27.

231 *In re Estate of Fawcett*, 55 S.W.3d 214, 220 (Tex. App.—Eastland 2001, pet. denied) (emphasis added) (holding summary judgment evidence raised a fact issue on whether fiduciary relationship existed); *see also Willis v. Donnelly*, 118 S.W.3d 10, 31–32 (Tex. App.—Houston [14th Dist.] 2003), *aff'd in part, rev'd in part*, 199 S.W.3d 262 (Tex. 2006) (stating that fiduciary relationship may be created "through the repurchase of a shareholder's stock in a closely held corporation" or "in certain circumstances in which a majority shareholder in a closely held corporation dominates control over the business"); *Allen v. Devon Energy Holdings, L.L.C.*, 367 S.W.3d 355, 391-97 (Tex. App.—Houston [1st Dist.] 2012, pet. 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) (case settled in 2013 while writ of error pending); *Redmon v. Griffith*, 202 S.W.3d 225, 237, 240 (Tex. App.—Tyler 2006, pet. denied), *disapproved of by Ritchie v. Rupe*, 443 S.W.3d 856 (Tex. 2014) (a contract for the repurchase of a shareholder's stock in a closely-held corporation may also create a fiduciary relationship when a majority shareholder dominates control over the business or the shareholders operate more as partners than in strict compliance with corporate formalities); *Miller v. Miller*, 700 S.W.2d 941, 945–46 (Tex. App.—Dallas 1985, writ ref'd n.r.e.) (concluding, in lawsuit brought to rescind transfer of stock in closely-held corporation based on purchaser's nondisclosure of information, that jury's finding of confidential relationship was supported by evidence of the defendant's position as a founder, officer, and director of company with inside knowledge of its affairs and prospects).

232 *See infra* notes 275-279 and related text.

233 *Gearhart*, 741 F.2d at 719.

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

235 *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).

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

(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.[237] 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.[238]
>
> In *Ritchie v. Rupe*,[239] 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. (citations omitted)

Texas courts also hold that a fiduciary owes to its principal a strict duty of "good faith and candor,"[240] including full disclosure respecting matters affecting the principal's interests.[241] There is a "general prohibition against the fiduciary using his relationship with the corporation to benefit his personal interest."[242]

The Tex. Corp. Stats. 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 statutory conditions are met. In general, the 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.[243]

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[237] *A. Copeland Enters. Inc. v. Guste*, 706 F. Supp. 1283, 1291 (W.D. Tex. 1989); *Milam v. Cooper Co.*, 258 S.W.2d 953, 956 (Tex. Civ. App.—Waco 1953, writ ref'd n.r.e.); *see* Kendrick, *The Interested Director in Texas*, 21 Sw. L.J. 794 (1967).

[238] *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*).

[239] 443 S.W.3d at 887.

[240] *See infra* notes 252-253 and related text.

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

[242] *NRC, Inc. v. 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).

[243] TBOC § 21.418; TBCA art. 2.35-1. *See infra* notes 460-465 and related text.

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.[244]

(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*,[245] a Federal District Court applying Texas law held that there is an absence of good faith when a board "abdicate[s] [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 patent, license, or an entire business.[246] The central question is whether or not the director has appropriated something for himself that, in all fairness, should belong to his corporation.[247]

Landon v. S & H Marketing Group, Inc.[248] 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.[249] The duty of candor, however, may not allow a

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244 TBOC § 2.101(21), TBCA art. 2.02(20); *see infra* note 456 and related text.

245 844 F. Supp. 300, 306 (N.D. Tex. 1994).

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

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

248 82 S.W.3d 666, 672 (Tex. App.—Eastland 2002, no pet.).

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.[250] 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.[251] 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 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.[252] The duty of candor applies when a director is communicating with the corporation regarding a business opportunity.[253]

(b) Care.

(1) Business Judgment Rule. 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.[254]

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249 *Scruggs Management Services, Inc. v. Hanson*, No. 2-05-413-CV, 2006 WL 3438243, at *7-8 (Tex. App.—Fort Worth, Nov. 30, 2006, pet. denied).

250 *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.).

251 *Landon v. S & H Marketing Group, Inc.*, 82 S.W.3d 666, 681 (Tex. App.—Eastland 2002, no pet.).

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

253 *See supra* note 250 and related text.

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

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*,[255] 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: "[t]he 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*[256] the year before and the Fifth Circuit in *Gearhart*,[257] the Texas Supreme Court in *Sneed v. Webre* cited and quoted from the early Texas decision of *Cates v. Sparkman*[258] 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 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.[259]

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.[260]

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

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255 465 S.W.3d 169, 173 (Tex. 2015).

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

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

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

259 465 S.W.3d at 178.

260 *Gearhart*, 741 F.2d at 723 n.9.

noninterested corporate director unless the challenged action is *ultra vires* or is tainted by fraud."[261]

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."[262] These decisions, however, "appear to be the product of the special treatment banks may receive under Texas law" and likely will not be followed to hold directors "liable for gross negligence under Texas law as it exists now" in other businesses.[263]

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."[264] In *FDIC v. Harrington*, the Court concluded "that a director's total abdication of duties falls within this definition of gross negligence."[265]

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.[266]

(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.[267]

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261 *Gearhart*, 741 F.2d at 721.

262 *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).

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

264 *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)).

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

266 *Gearhart*, 741 F.2d at 723 n.9.

267 TBOC § 3.102 provides:

(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.[268] The liability of directors may not be so limited or eliminated, however, in connection with breaches of the duty 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.[269] Officers do not have the benefit of the limitation of director liability authorized in the Tex. Corp. Stats.[270]

(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.[271] 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*[272] 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."[273] 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*

> 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:
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> (1) an officer or employee of the entity;
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> (2) legal counsel;
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> (3) a certified public accountant;
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> (4) an investment banker;
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> (5) a person who the governing person reasonably believes possesses professional expertise in the matter; or
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> (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.

268 TBOC § 7.001; TMCLA art. 1302-7.06; *see supra* notes 254-266 and related text.

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

270 *See infra* note 358.

271 *Gearhart*, 741 F.2d at 719.

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

273 *Id.* at 357.

> 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 act . . . .[274]

(2) Informal Fiduciary Duties. In *Ritchie v. Rupe*,[275] after reversing a lower court judgment on the ground that minority shareholder oppression is not a cause of action in Texas, the Texas Supreme Court remanded to the Court of Appeals plaintiff's fiduciary duty claim against directors of the corporation that was "not based on the formal fiduciary duties that officers and directors owe to the corporation by virtue of their management action," but on "an informal fiduciary relationship that 'existed between' plaintiff and defendant."[276] The Supreme Court in a footnote explained that "an informal fiduciary duty may arise from 'a moral, social, domestic or purely personal relationship of trust and confidence,' and its existence is generally a question of fact for the jury."[277]

On remand, the Court of Appeals held that "there is no evidence of a relationship of trust and confidence to support a finding of an informal fiduciary duty" and thus did not address whether an informal fiduciary duty was breached.[278] The Court of Appeals explained informal fiduciary duties as follows:

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274 *Id.*

275 443 S.W.3d 856 (Tex. 2014); *see supra* notes 221 and 256 and *infra* notes 602-611.

276 443 S.W.3d at 891-892.

277 443 S.W.3d at 892 note 63.

278 *Ritchie v. Rupe*, No. 05-08-00615-CV, 2016 WL 145581, at *2-3 (Tex. App.—Dallas Jan. 12, 2016), pet. filed; the jury charge (the wording of which was not at issue on appeal as no objection was raised thereto by either party at trial) asked the jury:

> Did a relationship of trust and confidence exist between any of the below-named individuals and Ann Rupe, as Trustee for the Dallas Gordon Rupe, III 1995 Family Trust?
>
> [1.] A relationship of trust and confidence existed if Ann Rupe, as Trustee for the Dallas Gordon Rupe, III 1995 Family Trust, justifiably placed trust and confidence in those named below to act in the Dallas Gordon Rupe, III 1995 Family Trust's best interest. Ann Rupe's subjective trust and feelings alone do not justify transforming arm's-length dealings into a relationship of trust and confidence.
>
> [2.] A confidential relationship exists where influence has been acquired and abused, and confidence has been reposed and betrayed.
>
> [3.] Co-shareholders in a closely held corporation typically do not owe fiduciary duties to fellow shareholders. 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. For a majority shareholder to owe a fiduciary duty to minority

The fiduciary duty alleged in this case is an informal fiduciary duty between Rupe and Dennard, Ritchie, and Lutes. Informal fiduciary relationships may "arise from 'a moral, social, domestic, or purely personal relationship of trust and confidence.'" *Meyer v. Cathey*, 167 S.W.3d 327, 331 (Tex. 2005) (quoting *Associated Indem. Corp. v. CAT Contracting, Inc.*, 964 S.W.2d 276, 287 (Tex. 1998)). Informal fiduciary duties are not owed in business transactions unless the special relationship of trust and confidence existed prior to, and apart from, the transaction(s) at issue in the case. *Id.* (quoting *Associated Indem.*, 964 S.W.2d at 288).

An informal fiduciary relationship exists "where, because of family relationship or otherwise, [one party] is in fact accustomed to be guided by the judgment or advice" of the other. *Thigpen v. Locke*, 363 S.W.2d 247, 253 (Tex. 1962). "The existence of the fiduciary relationship is to be determined from the actualities of the relationship between the persons involved." *Id.* "In order to give full force to contracts, we do not create such a relationship lightly." *Schlumberger Tech. Corp. v. Swanson*, 959 S.W.2d 171, 177 (Tex. 1997).

The Texas Supreme Court has held that a confidential relationship "exists where a special confidence is reposed in another who in equity and good conscience is bound to act in good faith and with due regard to the interest of the one reposing confidence." *See Tex. Bank & Trust Co. v. Moore*, 595 S.W.2d 502, 507 (Tex. 1980) (quoting *Lappas v. Barker*, 375 S.W.2d 248, 251 (Ky. 1964)). Thus, "[a] person is justified in placing confidence in the belief that another party will act in his or her best interest only where he or she is accustomed to being guided by the judgment or advice of the other party, and there exists a long association in a business relationship, as well as personal relationship." *Hoggett v. Brown*, 971 S.W.2d 472, 488 (Tex. App.—Houston [14th Dist.] 1997, pet. denied). Confidential relationships may arise when the parties have dealt with each other in such a manner for a long period of time that one party is justified in expecting the other to act in its best interest. *Ins. Co. of N. Am. v. Morris*, 981 S.W.2d 667, 674 (Tex. 1998).

"[M]ere subjective trust alone is not enough to transform arms-length dealing into a fiduciary relationship." *Thigpen*, 363 S.W.2d at 253. Rather, in

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shareholders, you must find that the majority shareholder dominates control over the business.

The jury answered "Yes" as to each of Dennard, Ritchie, and Lutes as co-trustees of their respective trusts.

Because the parties had not objected at trial to the wording of the foregoing jury instructions, the Court of Appeals accepted them as the law of the case and did not address whether those jury instructions would be appropriate for another case or accurately state the Texas law on informal fiduciary duties. *Cf.* PJC 104.1 Question and Instruction—Existence of Relationship of Trust and Confidence, *Texas Pattern Jury Charges* (2014) for another form of question and instruction to submit the existence of an informal fiduciary relationship (which it said is commonly referred to as a "relationship of trust and confidence" or a "confidential relationship") to a jury.

> order to establish the existence of an informal fiduciary relationship, the record must show that one of the parties actually relied on the other "for moral, financial, or personal support or guidance." *Trostle v. Trostle*, 77 S.W.3d 908, 915 (Tex. App.—Amarillo 2002, no pet.). An informal fiduciary relationship requires proof that, because of a close or special relationship, the plaintiff "is in fact accustomed to be guided by the judgment or advice" of the other. *Gregan v. Kelly*, 355 S.W.3d 223, 228 (Tex. App.—Houston [1st Dist.] 2011, no pet.) (quoting *Thigpen*, 363 S.W.2d at 253).[279]

In holding that the defendants did not owe informal fiduciary duties to plaintiff, the Court of Appeals recited evidence that one of the defendants had family relationships with plaintiff and another one of the defendants had done unrelated legal work for plaintiff's family, but also recited (and found controlling) evidence that showed plaintiff had serious disagreements with defendants over various family matters. In so holding the Court of Appeals in effect read the jury instructions[280] as requiring for a jury finding of the "relationship of trust and confidence" necessary for finding an informal fiduciary duty the existence of each of (i) "justifiably placed trust and confidence," (ii) "a confidential relationship...where influence has been acquired and abused, and confidence has been reposed and betrayed," and (iii) "a contract or confidential relationship…between them in addition to the corporate relationship…[because] [f]or a majority shareholder to owe a fiduciary duty to minority shareholders, [the jury] must find that the majority shareholder dominates control over the business." Thus, being a controlling shareholder alone would not support a finding of an informal fiduciary relationship under those jury instructions as interpreted by the Court of Appeals, and the evidence of disagreements between the minority shareholder and the alleged controllers made any reliance upon the controllers unjustifiable in that case. Because the parties had not objected at trial to the wording of those jury instructions, the Court of Appeals accepted them as the law of the case and did not address whether those jury instructions would be appropriate for another case or accurately state the Texas law on informal fiduciary duties.

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."[281] 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.[282] The Delaware Court of Chancery has summarized the duty of loyalty as follows:

> 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

279 *Ritchie v. Rupe*, *supra* 2016 WL 145581, at *4.

280 *See supra* note 278.

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

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

> 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.[283]

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;[284] 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 corporation;[285] insider trading; and actions that have the purpose or practical effect of

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283 *Solash v. Telex Corp.,* No. 9518, 9528, 9525, 1988 WL 3587, at *7 (Del. Ch. Jan. 19, 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.

284 *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 *info*GROUP, 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."

285 *Kahn v. Kolberg Kravis Roberts & Co., L.P.*, 23 A.3d 831, 837-838 (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

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.[286]

Like Texas, Delaware embraces 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 statutory 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.[287]

(2) Good Faith. Good faith is far from a new concept in Delaware fiduciary duty law.[288] 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.*[289] recognized the duty of good faith as a distinct directorial duty.[290] 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.[291]

The concept of good faith is also a limitation on the ability of entities to rely on Delaware statutes.[292] In one of the early, landmark decisions analyzing the contours of the duty of loyalty,

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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 *43 or *2-3 (Del. Ch. Dec. 20, 2013); *In re Primedia, Inc. S'holders Litig. (Primedia II)*, 67 A.3d 455, 459 (Del. Ch. 2013).

286 *Crescent/Mach I Partners, L.P. v. Turner*, 846 A.2d 963, 983 n.50 (Del. Ch. 2000); *Strassburger v. Earley*, 752 A.2d 557, 581 (Del. Ch. 2000).

287 *See infra* notes 458-459 and related text.

288 *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.

289 634 A.2d 345, 361 (Del. 1993).

290 *See* Strine et al, *supra* note 288.

291 911 A.2d 362, 369-370 (Del. 2006).

292 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*,

the Delaware Supreme Court observed that "no hard and fast rule can be formatted" for determining whether a director has acted in "good faith."[293] 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.[294]

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."[295]

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.[296] However, DGCL § 102(b)(7) also expressly provides that directors cannot be protected from liability for either actions not taken in good faith[297] or breaches of the duty of loyalty.[298] A finding of a lack

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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).

293 *See Guth*, 5 A.2d at 510.

294 *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).

295 *In re Disney*, 906 A.2d at 63.

296 *See infra* notes 451-455 and related text.

297 *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 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).

298 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 or 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.

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."[299] 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.[300] 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.[301]

(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."[302] Waste is a derivative claim.[303]

(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 act[304] – i.e., they act in bad faith.[305]

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299 DGCL §§ 145(a)-(b).

300 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).

301 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.

302 *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 137 (Del. Ch. 2009). *See also Sample v. Morgan*, 914 A.2d 647, 669-70 (Del. Ch. 2007).

303 *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.").

304 *See* Appendix D (*Business Leaders Must Address Cybersecurity Risk*) 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.").

305 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).

In an important Delaware Chancery Court decision on this issue, *In re Caremark International, Inc. Derivative Litigation*,[306] 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.[307]

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."[308] 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."[309] 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.

Second, *Caremark* noted that "the level of detail that is appropriate for such an information system is a question of business judgment,"[310] 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.[311] As a result, "[a]ny action seeking recovery for losses would logically entail a judicial determination of proximate cause."[312] This holding indicates that a loss to the corporation is not itself evidence of an inadequate information

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306 698 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).

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

308 *Id.*

309 *Id.* at 971.

310 *Id.* at 970.

311 *Id.*

312 *Id.* at 970 n.27.

and reporting system. Instead, the Court will focus on the adequacy of the system overall and whether a causal link exists.[313]

In *Stone v. Ritter*[314] 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*,[315] . . . 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."

(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.*[316] sets forth a widely quoted test for determining whether a director or officer wrongfully has diverted a corporate opportunity:

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313 *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).

314 911 A.2d 362, 365 (Del. 2006).

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

316 5 A.2d 503, 510-11 (Del. 1939).

> 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.*[317] 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 wrongfully employed the resources of the corporation in pursuing or exploiting the opportunity. *Guth*, 5 A.2d at 509.
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> 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.[318] 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.

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[317] 673 A.2d 148 (Del. 1996).

[318] DGCL § 122(17).

(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.[319] This principle is often memorialized in corporate policies.[320] In *Shocking Technologies, Inc. v. Michael*,[321] 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 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 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."

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.

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319 *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).

320 *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.

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

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.[322]

(7) Candor/Disclosure in Proxy Statements and Prospectuses. Under Delaware law, when directors solicit stockholder action, they must "disclose fully and fairly all material information within the Board's control."[323] Delaware has adopted the standard of materiality used under the federal securities laws that information is material "if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."[324] Information is material if, from the perspective of a reasonable stockholder, there is a substantial likelihood that it "significantly alter[s] the 'total mix' of information made available."[325]

(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.[326] In other instances, the omissions complained of are found to be immaterial.[327]

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322 *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

323 *Stroud v. Grace*, 606 A.2d 75, 84 (Del. 1992); *In re Trulia, Inc. Stockholder Litigation*, C.A. No. 10020-CB (Del. Ch. Jan. 22, 2016).

324 *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 944 (Del. 1985) (adopting materiality standard of *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976)); *Trulia*, *supra* note 323.

325 *Arnold v. Soc'y for Sav. Bancorp*, 650 A.2d 1270 at 1277; *Trulia*, *supra* note 323.

326 *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.

Directors can, and in larger transactions typically do, rely on expert advice in the form of an investment banker's ("banker") fairness opinion. 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 statement disclosures regarding the banker's process and the underpinnings of the fairness opinion are challenged.[328]

(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'."[329]

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.[330] Directors are not

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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).

327 In *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.

328 In 2014 94.9% of transactions over $100 million were subject to litigation (up from 39.3% in 2005). *In re Trulia, Inc. Stockholder Litigation*, C.A. No. 10020-CB (Del. Ch. Jan. 22, 2016), in which the Chancellor approved a settlement of duty of candor litigation where the only benefit the stockholders received was additional disclosure and signaled that disclosure only settlements would henceforth be more vigilantly scrutinized to see that the stockholders receive benefits commensurate with the releases received by the defendants. *See* Hon. Justice Myron Steele, *Contemporary Issues for Traditional Director Fiduciary Duties*, University of Arizona (August 1, 2012).

329 *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 552-**Error! Bookmark not defined.** and related text.

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

required, however, "to read in haec verba every contract or legal document,"[331] or to "know all particulars of the legal documents [they] authorize[ ] for execution."[332]

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.[333] "Delaware's current understanding of gross negligence is conduct that constitutes reckless indifference or actions that are without the bounds of reason."[334]

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 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.[335]

(2) Business Judgment Rule Not Applicable When Board Conflicted. In *Gantler v. Stephens*,[336] 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.[337]

(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.[338]

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

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

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

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

335 *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.").

336 965 A.2d 695, 710 (Del. 2009).

337 965 A.2d 695, 705 (Del. 2009).

338 *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.").

(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.[339]

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.[340] 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),[341] 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.[342] 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,[343] intentional misconduct, knowing violations of law, obtaining improper personal benefits, or paying dividends or approving stock repurchases in violation of DGCL § 174.[344] Officers do not have the benefit of the limitation of director liability authorized by DGCL § 102(b)(7).[345]

(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.[346] A buyer whose hard negotiations lead to the target's Board making concessions in

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339 DGCL § 141(e). *See infra* notes 451-455 and related text.

340 *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 135 (Del. Ch. 2009).

341 *See infra* notes 451-455 and related text.

342 *See infra* notes 451-455 and related text.

343 *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 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.).

344 DGCL § 102(b)(7).

345 *See infra* notes 451-455 and related text.

346 *Malpiede v. Townson*, 780 A. 2d 1075, 1096 (Del. 2001).

violation of its fiduciary duties is ordinarily not subject to aider and abettor liability,[347] but cannot insist on and incorporate terms that take advantage of a conflict of interest that its fiduciary counterpart faces.[348]

In *RBC Capital Markets, LLC v. Joanna Jervis*,[349] the Delaware Supreme Court affirmed the Delaware Chancery Court's post-trial decision in *In re Rural/Metro Corp. S'holders Litig.*[350] 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 and its subsequent decision setting 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).[351]

In affirming the Chancery Court holding that if a "[i]f the third party knows that the board is breaching its duty of care and participates in the breach by misleading the board or creating the informational vacuum, then the third party can be liable for aiding and abetting," the Supreme Court explained:

> It is the aider and abettor that must act with *scienter*. The aider and abettor must act "knowingly, intentionally, or with reckless indifference . . .[;]" that is, with an "illicit state of mind." To establish *scienter*, the plaintiff must demonstrate that the aider and abettor had "actual or constructive knowledge that their conduct was legally improper." Accordingly, the question of whether a defendant acted with *scienter* is a factual determination. The trial court found that, "[o]n the facts of this case, RBC acted with the necessary degree of *scienter* and can be held liable for aiding and abetting." The evidence supports this finding.
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> RBC knowingly induced the breach by exploiting its own conflicted interests to the detriment of Rural and by creating an informational vacuum. RBC's knowing participation included its failure to disclose its interest in obtaining a financing role in the EMS transaction and how it planned to use its engagement as Rural's advisor to capture buy-side financing work from bidders for EMS; its knowledge that the Board and Special Committee were uninformed about Rural's value; and its failure to disclose to the Board its interest in providing the winning bidder in the Rural process with buy-side financing and its eleventh-hour attempts to secure that role while simultaneously leading the

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347 *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.).

348 *Pontiac Gen. Employees Ret. Sys. v. Ballantine*, C.A. No. 9789-VCL, 2014 WL 6388645 (Del. Ch. Oct. 14, 2014) (TRANSCRIPT)). *See infra* note 640-643 and related text.

349 No. 140, 2015 (Del. Nov. 30, 2015). *See* John Legaré Williams, *Delaware Insider: Rural Metro: Gulping Advisers and Practitioner Guidance*, BUS. L. TODAY (Jan. 2016).

350 88 A.3d 54 (Del. Ch. 2014).

351 *In re Rural/Metro Corp. S'holders Litig.*, 102 A.3d 205, 224 (Del. Ch. Oct. 10, 2014).

> negotiations on price. RBC's desire for Warburg's business also manifested itself in its financial analysis, provided by RBC the day the Board approved the merger. RBC's illicit manipulation of the Board's deliberative processes for self-interested purposes was enabled, in part, by the Board's own lack of oversight, affording RBC "the opportunity to indulge in the misconduct which occurred." The Board was unaware of RBC's modifications to the valuation analysis, back-channel communications with Warburg, and eleventh-hour attempt to capture at least a portion of the acquirer's buy-side financing business. RBC made no effort to advise the Rural directors about these contextually shaping points. The result was a poorly-timed sale at a price that was not the product of appropriate efforts to obtain the best value reasonably available and, as the trial court found, a failure to recognize that Rural's stand-alone value exceeded the sale price.
>
> RBC's failure to fully disclose its conflicts and ulterior motives to the Board, in turn, led to a lack of disclosure in the Proxy Statement. The Proxy Statement included materially misleading information that RBC presented to the Board in its financial presentation and omitted information about RBC's conflicts.
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> The manifest intentionality of RBC's conduct—as evidenced by the bankers' own internal communications—is demonstrative of the advisor's knowledge of the reality that the Board was proceeding on the basis of fragmentary and misleading information. Propelled by its own improper motives, RBC misled the Rural directors into breaching their duty of care, thereby aiding and abetting the Board's breach of its fiduciary obligations.

The Supreme Court, however, rejected the Chancery Court's view that an investment banker generally has an obligation to act as a "gatekeeper" to prevent the Board from breaching its fiduciary duty. Rather, the Supreme Court focused on RBC's *scienter* by failing to disclose its conflicts and furnishing incomplete and misleading information to the Board.

In re Zale Corporation Stockholders Litigation[352] involved claims against the Board of Zale Corporation for approving a merger with Signet Jewelers Limited with an inadequate price, unreasonable deal protection provisions and other failings, and a claim against Merrill Lynch as financial adviser to Zale for aiding and abetting the alleged fiduciary duty violations by the Zale Board. As Zale's charter contained a DGCL § 102(b)(7) exculpation provision,[353] the directors were dismissed as no duty of loyalty claims were credibly alleged. The crux of the aiding abetting claim was that Merrill Lynch, as it was being engaged, told the Board that it had limited prior relationships and no conflicts with Signet when in fact it had received more than $2 million in fees from Signet during the prior two years and had very recently proposed to Signet that it acquire Zale. Merrill later disclosed these facts after the merger agreement was signed but before the merger proxy statement was distributed to stockholders. The Board's failure to more thoroughly scrutinize Merrill Lynch's relationships was alleged as the predicate Board duty of care breach for Merrill's aiding and abetting liability. Based on the Delaware Supreme Court's

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352 Consol. C.A. No. 9388-VCP (Del. Ch. Oct. 29, 2015).

353 *See supra* notes 341-344 and *infra* notes 451-455 and related text.

decision in *Corwin v. KKR Financial Holdings LLC*,[354] the Chancery Court concluded "that when reviewing a board of directors' actions during a merger process after the merger has been approved by a majority of disinterested stockholders in a fully informed vote, the standard for finding a breach of the duty of care under BLR [the business judgment rule] is gross negligence." In this context the Chancery Court wrote that "the core inquiry . . . is whether there was a real effort to be informed and exercise judgment." The Court was troubled by the conduct of Merrill, but held that it was not "reasonably conceivable that the [Board] conduct amounted to 'reckless indifference or a gross abuse of discretions'" or that "the facts 'suggest a *wide* disparity between the process the directors used and [a process] which would have been rational.'" Because there were not sufficient allegations of a predicate fiduciary duty breach by the Board, the aiding and abetting claims against Merrill Lynch were dismissed.[355]

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 as to matters entrusted to their discretion comparable to those of directors,[356] and may be sued in a corporate derivative action just as a director may be.[357] Officers do not have the benefit of exculpation under TBOC § 7.001 and DGCL § 102(b)(7).[358]

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

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354 *Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304 (Del. 2015), *affirming In re KKR Financial Holdings LLC Shareholder Litigation*, 101 A.3d 980 (Del. Ch. Oct. 14, 2014); *see infra* note 587 and related text.

355 In so holding, the Court in *Zale* distinguished the Chancery Court decision in *In Re TIBCO Software, Inc. Stockholders Litigation*, Consol. C.A. No. 10319-CB (Del. Ch. Oct. 20, 2015) (emphasis in original) (quoting *Guttman v. Huang*, 823 A.2d 492, 508 n. 39 (Del. Ch. 2003)) as follows:

> Although the board in *TIBCO* was exculpated from monetary liability for a breach of the duty of care due to the 102(b)(7) provision in its charter, the Court found it reasonably conceivable that the financial advisor aided and abetted the board's duty of care breach by withholding the acquirer's reliance on the erroneous share count [the number of outstanding shares set forth in the merger agreement] in order to increase the odds of the merger being consummated, thereby earning a significantly larger fee for its services. * * * Whereas in *TIBCO* the Court focused on the board's duty to investigate and inquire further after the disclosure of the share count error, the focus of the inquiry in this case was on whether the Director Defendants discharged their duty of care when they first engaged Merrill Lynch.

356 *Gearhart Indus., Inc. v. Smith Int'l*, 741 F.2d at 719 (fiduciary obligations of corporate officers are often identical to those of directors).

357 *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).

358 *See infra* notes 451-455 and relatedl text.

relationship," and "a corporate shareholder has no individual cause of action for personal damages caused solely by a wrong done to the corporation."[359] The Texas Supreme Court in *Sneed v. Webre*[360] 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."[361]

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."[362] 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*,[363] which resulted from the failed marriage between Disney and its former President Michael Ovitz, is instructive as to the duties of an officer.[364] 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.

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359 *Redmon v. Griffith*, 202 S.W.3d 225, 234 (Tex. App.—Tyler 2006, pet. denied), *disapproved of by Ritchie v. Rupe*, 443 S.W.3d 856 (Tex. 2014). *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).

360 *See supra* note 255 and related text.

361 965 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 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).

362 *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.").

363 906 A.2d 27, 35 (Del. 2006).

364 *See infra* notes 526-532 and related text (discussing *Disney* with respect to director duties when approving executive officer compensation).

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 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.[365]

A corporate officer is an agent of the corporation,[366] and their fiduciary duties are those of an agent as defined in the law of agency.[367] If an officer commits a tort while acting for the

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365 *See generally Disney*, 906 A.2d at 35.

366 *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."
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> * * *
>
> 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).

367 *See Lake v. Premier Transp.*, 246 S.W.3d 167, 171 (Tex. App.—Tyler 2007); *Burch v. Hancock*, 56 S.W.3d 257, 261 (Tex. App.—Tyler 2001); *see Miller v. McDonald (In re World Health Alternatives, Inc.)*, 385 B.R. 576, 2008 Bankr. LEXIS 1012, 49 Bankr. Ct. Dec. 235 (Bankr. D. Del. April 2008); *cf. Wright v. Sage Engineering, Inc.*, 137 S.W.3d 238, 250 (Tex. App.—Houston [1st Dist.] 2004).

corporation, under the law of agency, the officer is liable personally for his actions.[368] The corporation may also be liable under *respondeat superior*.

2.6.6. Preferred Stock Rights and Duties.

(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 nature[369] and are governed by the express provisions of the certificate of incorporation[370] of the issuer.[371] The preferential rights, powers or privileges must be "expressly and clearly stated" and "will not be presumed or implied."[372] When construing preferred stock provisions, standard rules of contract interpretation are applied to determine the intent of the parties.[373] The certificate of incorporation is read as a whole and, to the extent possible, in a

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368 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).

369 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.

370 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. TBOC § 21.156; TBCA art. 2.13; 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").

371 *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).

372 *Elliott Associates, L.P. v. Avatex Corp.*, 715 A.2d 843, 852-53 (Del. 1998).

373 *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).

manner that permits a reconciliation of all of its provisions.[374] The implied contractual duty of good faith and fair dealing is applicable to preferred stock.[375]

(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.[376] Preferred stockholders are entitled to share the benefits of the fiduciary duties of care and loyalty.[377] 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.[378] 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.[379]

(c) Conflicting Interests of Common and Preferred in M&A Transaction. A corporation's common and preferred stockholders may have conflicting interests, particularly if

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374 *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).

375 *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.").

376 *Jedwab v. MGM Grand Hotels, Inc.*, 509 A.2d 584, 594 (Del. Ch. 1986).

377 *Jackson Nat'l Life Ins. Co. v. Kennedy,* 741 A.2d 377, 387-389 (Del. Ch. 1999).

378 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).

379 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)).

its financial condition deteriorates as in the context of a recapitalization or sale of the business.[380] Board ties to one class of stock can result in judicial scrutiny.[381]

(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 DGCL or TBOC, as the case may be.[382] A certificate of incorporation may either authorize special voting preferences or it may deny all voting rights to the holders of preferred stock. [383] If there is no special provision in 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.[384] 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.[385] 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.[386]

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.[387] DGCL § 242(b)(2) provides generally with respect

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380 Mark A. Morton, *First Principles for Addressing the Competing Interests of Common and Preferred Stockholders in an M&A Transaction* (Sept. 2009).

381 *See*, *e.g.*, *In re Trados Incorporated Shareholder Litigation*, No. 1512-VCL, 2009 WL 2225958, at *1 (Del. Ch. July 24, 2009) ("*Trados I*") and *In re Trados Inc. Shareholder Litig.*, C.A. No. 1512-VCL, 2013 WL 4511262, at *9 (Del. Ch. Aug. 16, 2013) ("*Trados II*").

382 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).

383 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 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…"

384 TBOC §§ 21.363, 21.364, 21.365 and 21,366; DGCL § 212(a).

385 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.

386 TBOC § 21.364; DGCL §§ 151 and 242.

387 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

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.*,[388] 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.[389] In contrast, in *Elliott*

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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.

388 583 A.2d 962, 964 (Del. Ch. 1989), *aff'd*, 567 A.2d 419 (Del. 1989).

389 *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).

Assocs., L.P. v. Avatex Corp.[390] 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 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."[391]

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.[392] 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.[393] A merger in which all of a corporation's stock is converted into cash 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.[394] 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

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390 715 A.2d 843, 855 (Del. 1998).

391 *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.'").

392 TBOC § 21.457; TBCA art. 5.03(F).

393 TBOC § 21.364.

394 *Id.*

not substantially impaired,[395] (b) mergers affected to create a holding company,[396] and (c) short form mergers.[397]

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.[398] 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.[399] 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,[400] a disinterested Board would have the power to determine whether to bring or dismiss a breach of fiduciary duty claim for the corporation.[401]

Both Delaware[402] and Texas[403] law authorize an action brought in the right of the corporation by a shareholder against directors or officers for breach of fiduciary duty.[404] Such an action is called a "derivative action."

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395 TBOC § 21.459(a); TBCA art. 5.03(G).

396 TBOC §§ 10.005, 21.459(b); TBCA art. 5.03(H)–5.03(K).

397 TBOC §§ 10.006, 21.459(b); TBCA art. 5.16(A)–5.16(F).

398 *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.3d 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 359 and related text, and *infra* notes 472-474 and related text.

399 *Redmon v. Griffith*, 202 S.W.3d 225, 233-234 (Tex. App.—Tyler 2006, pet. denied), *disapproved of by Ritchie v. Rupe*, 443 S.W.3d 856 (Tex. 2014); *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.").

400 DGCL § 141(a); *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244, 253-54 (Del. 2000).

401 *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").

402 DEL. CT. OF CHANCERY R. 23.1.

403 TBOC §§ 21.551-21.563; TBCA art. 5.14.

404 TBOC §§ 21.551-21.563; TBCA art. 5.14.

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.[405] 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 . . . ?"[406] 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.[407]

In *Gentile v. Rossette*,[408] 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 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.[409] 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.[410] Delaware and Texas differ in cases in which making such a demand upon the 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.

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405 *See infra* note 419 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 406-408 and related text (highlighting Delaware case law allowing a derivative claim to be brought directly).

406 845 A.2d 1031, 1033 (Del. 2004).

407 951 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).

408 906 A.2d 91, 103 (Del. 2006).

409 DEL. CT. OF CHANCERY R. 23.1; TBOC § 21.553; TBCA art. 5.14(C).

410 TBOC § 21.558.

(b) Texas Derivative Actions.

(1) Standing; Demand. In Texas, a shareholder[411] 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) fairly and adequately represents the interests of the corporation in enforcing the right of the corporation.[412] Further, the plaintiff must remain a qualified shareholder throughout the derivative proceedings.[413]

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.[414] Moreover, a 90-day waiting period is required from the delivery of the demand notice until the commencement of a suit.[415] This waiting period can only be avoided if the shareholder is earlier notified that the Board has rejected his demand, or if irreparable injury to the corporation is being suffered or would result by waiting for the expiration of the 90-day period.[416]

The written demand must meet a stringent set of particularity requirements in order to satisfy the Tex. Corp. Stats.[417] Though much of the analysis done by the courts to evaluate

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411 "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 Sneed v. Webre*, 465 S.W.3d 169, 169, 189-92 (Tex. 2015).

412 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 shareholdes and no public trading market for its shares. *See infra* note 418 and related text.

413 *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 444-448 and related text.

414 TBOC § 21.553(a); TBCA art. 514(C)(1).

415 TBOC § 21.553; TBCA art. 5.14(C)(2).

416 TBOC § 21.553(b); TBCA art. 5.14(C)(2).

417 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.

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.

(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).[418] 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.[419]

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.[420]

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.[421] Just as the TBOC's demand and mandatory dismissal requirements do not apply to shareholder

418 *See Sneed v. Webre*, 465 S.W.3d 169, 169, 178-186 (Tex. 2015).

419 TBOC § 21.563 is substantively identical to TBCA art. 5.14.

420 *See supra* notes 202, 400-401 and related text.

421 TBOC § 21.563(a) defines "closely held corporation" to mean a corporation with less than 35 shareholders and no public market.

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 cause of action." [422] 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.[423]

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,"[424] 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.[425]

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 cororation's wholly owned

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422 *Sneed v. Webre*, 465 S.W.3d 169, 183 (Tex. 2015).

423 *Id.* at 193.

424 *See* TBOC §§ 21.701-21.763 regarding "close clorporations." 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.

425 *Ritchie v. Rupe*, 443 S.W.3d at 880-81.

subsidiary against the subsidiary's directors and officers for breach of fiduciary duties (a "Double Derivative Action").[426]

(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."[427] 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."[428] 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.'"[429]

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.'"[430]

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.[431] 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.'"[432]

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.[433] "Rather, demand will be excused based on a possibility of personal director liability only in the rare case when a 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

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426 *Sneed v. Webre*, 465 S.W.3d 169 (Tex. 2015).

427 *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 120 (Del. Ch. 2009).

428 *Id.*

429 *Id.*

430 473 A.2d 805, 814 (Del. 1984).

431 *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).

432 *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).

433 *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.

therefore exists.'"[434] 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.[435]

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.[436] Stockholders who obtained their shares in a merger lack derivative standing to challenge pre-merger actions.[437]

(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.[438]

(d) 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."[439]

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434 *Citigroup*, 964 A.2d at 121 (quoting *Aronson v. Lewis*, 473 A.2d 805, 815 (Del. 1984), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244, 253-54 (Del. 2000)).

435 *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 209-217 regarding the internal affairs doctrine.

436 *Ryan v. Gifford*, 918 A.2d at 359; DGCL § 327 (2013).

437 *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.*, Consol. C.A. 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.*

438 The essence of a Double Derivative Action in Delaware was summarized by the Delaware Supreme Court in *Lambrecht v. O'Neal*, 3 A.3d 277, 281 (Del. 2010). *See supra* note 426 regarding Double Derivative Actions under Texas law.

439 *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

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.[440] A narrow exception to Delaware's general non-survival 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."[441] 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.[442]

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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.").

440 *In re NYMEX Shareholder Litigation*, C.A. No. 3621-VCN, 2009 Del. Ch. LEXIS 176, at *35 (Del. Ch. Sept. 30, 2009).

441 *Parnes v. Bally Entm't Corp.*, 722 A.2d 1243, 1245 (Del. 1999).

442 *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)

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 Procedure[443] and Texas' prior derivative action provisions in the TBCA[444] have been

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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).

443 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: <u>First</u>, 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;" <u>Second</u>, 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 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).

444 *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 a 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

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.[445] 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.[446] Although Delaware law explicitly allows for direct suit in some fiduciary duty cases,[447] *Gearhart* held that under Texas

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termination proceeding was instituted to accomplish a valid business purpose, rather than to dispose of the derivative suit by a reverse stock split.").

445 *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 TBCA art. 5.03(M) might support survival was merely dicta. *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.

446 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:
>
> ~~(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.

447 *See supra* note 408 and related text.

law fiduciary claims in connection with a merger are the right of the corporation itself, not individual shareholders.[448]

2.6.8. Governing Authority and Document Limitations of Fiduciary Duties. Unlike the statutes governing partnerships and LLCs,[449] neither the Tex. Corp. Stats. nor the DGCL include provisions generally recognizing the principle of freedom of contract for corporations.[450] The Tex. Corp. Stats. and the 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, but none of them authorizes the limitation of liability of officers. 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 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.[451]

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448 *Gearhart Indus., Inc. v. Smith Int'l. Inc.*, 741 F.2d 707, 721 (5th Cir. 1984).

449 *See infra* notes 755-766, 815-852, and 932 and related text.

450 *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).

451 DGCL § 102(b)(7).

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.[452] DGCL § 102(b)(7) does not authorize the liability of directors to be so limited or eliminated for 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.[453] 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.[454]

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.[455]

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452 *Id.*

453 *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).

454 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.

455 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:
> >
> > > (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.

(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.[456] 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.[457]

(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. 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.[458] The question remains, however, whether approval by a majority 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.[459]

TMCLA art. 1302-7.06 provides substantially the same.

456 TBOC § 2.101(21), TBCA art. 2.02(20); DGCL § 122(17).

457 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.

458 *Fliegler v. Lawrence*, 361 A.2d 218, 222 (Del. 1976).

459 *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.
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> * * *
>
> [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

In 1985, Texas followed Delaware's lead in the area of interested director transactions and adopted TBCA article 2.35-1,[460] 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.[461] 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.[462] TBOC § 21.418 mirrors these clarifications. Under the Tex. Corp. Stats., if any one of these conditions is met, the contract will be considered valid notwithstanding the fact that the director or officer has an interest in the transaction.[463] These provisions rely heavily on the statutory definitions of "<u>disinterested</u>" contained in TBOC § 1.003 and TBCA art. 1.02. Under these definitions, a director will be considered "<u>disinterested</u>" 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.[464]

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.[465] Although the difference between

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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).

460 TBOC § 21.418; TBCA art. 2.35-1.

461 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.).

462 TBCA art. 2.35-1.

463 *Id.* art. 2.35-1(A); TBOC § 21.418(b).

464 TBOC § 21.418(b); TBCA art. 2.35-1(A).

465 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

the Texas and Delaware constructions is subtle, the distinction is significant and provides more

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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 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).

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.[466] 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.[467] 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)[468] the corporation may continue to be governed by its Board or a trustee may be appointed to administer its assets for the benefit of its creditors.[469] 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.[470] 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.[471] 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.[472] When the corporation is solvent, the directors owe fiduciary duties to the corporation and to the shareholders of the corporation.[473] The creditor's relationship to the corporation is contractual in nature. A solvent

466 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).

467 *Id.*

468 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.

469 *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).

470 *Cf. Torch*, 561 F.3d at 380; *Bernard Tech*, 2009 WL 426179 at *1.

471 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).

472 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).

473 *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)].

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.[474]

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."[475] When the corporation is both insolvent and has ceased doing business, the corporation's creditors become its owners and the 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.[476] 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.[477] 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."[478] The trust fund doctrine in Texas requires the directors and officers of an insolvent corporation to deal fairly with its

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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).

474 *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.").

475 *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.").

476 *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).

477 *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).

478 *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).

creditors without preferring one creditor over another or themselves to the injury of other creditors.[479] 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.[480]

In Delaware, the corporation need not have ceased doing business for that trust fund to arise and the directors to owe duties to creditors.[481] 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.[482]

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.[483] Rather, the shifting merely

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479 *Plas-Tex v. Jones*, No. 03-99-00286-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).

480 *Floyd*, 2006 WL 2844245 at *24.

481 *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).

482 *Decker v. Mitchell (In re JTS Corp.)*, 305 B.R. 529, 539 (Bankr. N.D. Cal. 2003).

483 *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,

exonerates the directors who choose to maintain the corporation's long term viability by considering the interests of creditors.[484]

(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).[485] 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."[486] Owing 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.[487]

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.[488] 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."[489]

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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).

484 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.'").

485 *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).

486 *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.").

487 *See Odyssey Partners, L.P. v. Fleming Cos., Inc.*, 735 A.2d 386, 420 (Del. Ch. 1999).

488 *Geyer*, 621 A. 2d at 789.

489 *Id.*

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,[490] 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.[491] 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.[492] 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."[493] 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.[494]

(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.[495] 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.[496]

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490 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.

491 *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).

492 *In re United Finance Corporation*, 104 F.2d 593, 598 (7th Cir. 1939).

493 *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).

494 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 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).

495 930 A.2d 92, 94 (Del. 2007); *cf.* Sabin Willett, *Gheewalla and the Director's Dilemma*, 64 BUS. LAW. 1087 (August 2009).

496 *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).

The Fifth Circuit followed *Gheewalla* in *Torch Liquidating Trust v. Stockstill*[497] 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 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. ***

[497] 561 F.3d 377, 383 (5th Cir. 2009).

> 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.[498]

Gheewalla was followed in *Quadrant Structured Products Co. Ltd. v. Vertin*,[499] 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.

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498 *Id.* at 384-88.

499 102 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).

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 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.[500] 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.[501]

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500 *N. Am. Catholic Educ. Programming Foundation Inc. v. Gheewalla*, 930 A2d 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); *Growe 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); *Askanase 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).

501 *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,*

Where directors of an insolvent corporation are interested, their conduct will likewise be judged by the standards that would have otherwise been applicable.[502] A director's stock ownership may call into question a director's independence where the creditors are the 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.[503]

In *Pereira v. Cogan*,[504] 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.[505] The U.S. District Court for the Southern District of New York ("SDNY") held *inter alia*, that (1) ratification by board of directors that

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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).

502 *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).

503 *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).

504 294 B.R. 449, 463 (S.D.N.Y. 2003).

505 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.

was not independent[506] of compensation that the CEO had previously set for himself, without 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;[507] (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

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506 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 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.

507 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.

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 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*[508] 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)[509] 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.[510]

(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

508 413 F.3d 330, 336 (2d Cir. 2005).

509 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).

510 *Geyer v. Ingersoll Pub. Co.*, 621 A. 2d 784, 789 (Del. Ch. 1992).

life beyond insolvency."[511] 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.[512] In recent years some federal courts embraced deepening insolvency claims and predicted that Delaware would recognize such a cause of action.[513] In *Trenwick America Litigation Trust v. Ernst & Young LLP*,[514] 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."[515] 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,"[516] 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.[517] 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.[518]

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511 *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).

512 *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") 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).

513 *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).

514 906 A.2d 168, 172 (Del. Ch. 2006).

515 *Id.* at 174.

516 *Trenwick Am. Litig. Trust v. Billett*, 931 A.2d 438 (Del. 2007).

517 *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).

518 *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*:

(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,[519] the conflict of interest rules may change in an insolvency situation.[520]

(g) Fraudulent Transfers. Both state and federal law prohibit fraudulent transfers.[521] 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."[522]

> 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, claims alleging a duty of care violation could be viewed as a deepening insolvency claim by another name.
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> 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).
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> 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.

519 *See supra* notes **Error! Bookmark not defined.**-465 and related text (discussing TBOC § 21.418 and TBCA art. 2.35-1).

520 *See Kahn v. Lynch Commc'ns Sys., Inc.*, 638 A.2d 1110, 1115 (Del. 1994).

521 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.

522 DEL. CODE ANN. tit. 6, § 1310.

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.[523] 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 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.[524] The objective is to follow a process that will resolve the inherent conflicts of interest,[525] comply with the requirements of other applicable laws, 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) *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*

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523 *See* Bruce F. Dravis, *The Role of Independent Directors after Sarbanes-Oxley*, 79 (ABA Bus. Sec. 2007).

524 *See id.* at 79-82.

525 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.

Disney Co. Derivative Litigation,[526] 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 trial[527] that Disney's directors had not breached their fiduciary duties in connection with the hiring or termination of Michael Ovitz as President of 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.[528]

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

526 906 A.2d 27, 35 (Del. 2006).

527 *In re The Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 697 (Del. Ch. 2005).

528 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).

payments . . . . Absent a demonstration that the transaction was fair to Disney, the transaction may be voidable at the discretion of the company."[529]

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.

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.[530] 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 addition, 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.[531] 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."[532]

(c) *Integrated Health*. In *Official Committee of Unsecured Creditors of Integrated Health Services, Inc. v. Elkins*,[533] 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

529 *In re The Walt Disney Co. Derivative Litig.*, C.A. No. 15452, 2004 WL 2050138, at *7 (Del. Ch. Sept. 10, 2004).

530 *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.*

531 *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).

532 *Id.* at 75.

533 C.A. No. 20228-NC, 2004 WL 1949290, at *1 (Del. Ch. Aug. 24, 2004).

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."[534] 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 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 <u>total lack</u> of deliberation discussed in *Disney* and the alleged <u>inadequate</u> deliberation in *Integrated Health*, the Chancery Court wrote:

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[534] *Id.* at *12.

> 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.[535]

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.[536]

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.

2.6.11. Non-Profit Corporations. The compensation of directors and officers of non-profit corporations can raise conflict of interest issues comparable to those discussed above in respect of the compensation of directors and officers of for-profit corporations.[537] 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").[538] 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.[539]

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535 *Id.* at *13 n.58.

536 *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.*

537 *See*, Evelyn Brody, *Principals of the Law of Nonprofit Organizations*, Tentative Draft No. 1 (American Law Institute, Feb. 2007).

538 *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.

539 *Id.* *See* Good Governance Practices for 501(c)(3) Organizations, http://www.irs.gov/pub/irs-tege/governance_practices.pdf.

The fiduciary duties of directors applicable to compensation process are comparable to those of a for-profit corporation discussed elsewhere herein.[540] 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.[541] To prove a breach of the duty of loyalty, it must be shown that the director was "*interested*" in a particular transaction.[542] 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."[543]

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.[544] 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."[545] "[T]he burden of proof is on the interested director to show that the action under fire is fair to the corporation."[546]

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*:

> 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.[547]

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540 *See* TBOC § 22.221.

541 *See supra* notes 254-266 and related text.

542 *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. 1989).

543 *Copeland*, 706 F. Supp. at 1290-91.

544 *See Gearhart*, 741 F.2d at 722; *Copeland*, 706 F. Supp. at 1291-92.

545 *Gearhart*, 741 F.2d at 720; *see also Copeland*, 706 F. Supp. at 1291.

546 *Gearhart*, 741 F.2d at 720; *see also Copeland*, 706 F. Supp. at 1291.

547 *Gearhart*, 741 F.2d at 723 (citations omitted) (quoting *Pepper v. Litton*, 308 U.S. 295, 306-07 (1939)).

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."[548]

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.[549] 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.[550] 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. . . .[551]

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.

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;

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548 *Id*. at 720.

549 *See Copeland*, 706 F. Supp. at 1290-91.

550 *See id*. at 1291-93.

551 *Gearhart*, 741 F.2d at 719 n.4.

(ii) *enhanced scrutiny* – for a decision to adopt or employ defensive measures[552] 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."[553] "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.'"[554]

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.'"[555] In *Van Gorkom*,

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552 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.

553 *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244, 253-54 (Del. 2000); *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).

554 *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).

555 *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).

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.[556]

(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.[557]

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.[558]

(i) Defensive Measures. In *Unocal Corp. v. Mesa Petroleum Co.*,[559] 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."[560] 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)[561] 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).[562]

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556 *Van Gorkom*, 488 A.2d at 874.

557 *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).

558 *QVC*, 637 A.2d at 45 (emphasis omitted).

559 493 A.2d 946, 954 (Del. 1985).

560 *Id.* at 954.

561 *Id.* at 954-55.

562 *Id.* at 955; *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1387-88 (Del. 1995).

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.[563]

(ii) Sale of Control. In *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,[564] 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.[565]

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563 965 A.2d 695, 705 (Del. 2009).

564 506 A.2d 173, 184 n.16 (Del. 1986).

565 *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, 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 305-315 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

Then in *Paramount Communications Inc. v. QVC Network Inc.*,[566] 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.[567]

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.*,[568] 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."[569] 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.[570]

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

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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.

566 637 A.2d 34, 36 (Del. 1994).

567 *Id.* at 43 (footnote omitted).

568 634 A.2d 345, 361 (Del. 1993).

569 *Id*. at 361.

570 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 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."

both [corporations] remain[s] in a large, fluid, changeable and changing market'"[571] as continuing shareholders in the target, the former acquired company shareholders retain the opportunity to receive a control premium.[572] In *QVC* a single person would have had control of the resulting corporation, effectively eliminating the opportunity for shareholders to realize a control premium.[573]

In *Lyondell Chemical Company v. Ryan*,[574] 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.[575] 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 directors exposed to personal liability (and possible monetary damages) for their conduct.[576] 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:

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571 *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)); s*ee 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."

572 *Id.*

573 *Id.*; *see also Paramount Commc'ns, Inc. v. Time, Inc.*, 571 A.2d 1140, 1150 (Del. 1989).

574 970 A.2d 235, 237 (Del. 2009).

575 *Ryan v. Lyondell Chem. Co.*, C.A. No. 3176-VCN, 2008 WL 2923427 (Del. Ch. July 29, 2008) *rev'd by Lyondell Chemical Company v. Ryan*, 970 A.2d 235 (Del. 2009); *see* J. Travis Laster and Steven M. Haas, *Reactions and Overreactions to Ryan v. Lyondell Chemical Co.*, 22 INSIGHTS No. 9, 9 (Sept. 2008).

576 *See supra* notes **Error! Bookmark not defined.**-301 and related text.

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.

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.[577]

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."[578] *Revlon* does not require a Board to obtain a valuation of the company, commence an auction or implement defensive measures just because the 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."[579] 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.

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577 970 A.2d at 235, 242-44.

578 *Id.* at 242.

579 *Id.*

- 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."[580] 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."[581]

- 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 *C&J Energy Services, Inc. v. City of Miami General Employees' and Sanitation Employees' Retirement Trust*,[582] 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.
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> 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."

580 *Id.* at 244.

581 *Id.* at 243.

582 107 A.3d 1049 (Del. 2014).

> 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.[583] 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 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.[584]

(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.[585] In reviewing Board action in transactions involving management, Board members or a principal shareholder, the Delaware Supreme Court has imposed an "entire fairness" standard.[586] While a stockholder

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583 *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.

584 *Id.*

585 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), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244, 253-54 (Del. 2000).

586 *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. 1989) (applying the standard set forth in *Weinberger*); *In re EZCORP Inc. Consulting Agreement Derivative Litigation*, C.A. No. 9962-VCL (Jan. 25, 2016), in which the Chancery Court applied the entire fairness standard of review to a challenge to a consulting agreement between a corporation and its controlling stockholder and explained:

> Under current law, the entire fairness framework governs any transaction between a controller and the controlled corporation in which the controller receives a non-ratable benefit. This is because "Delaware is more suspicious when the fiduciary who is interested is a controlling stockholder." Leo E. Strine, Jr., *The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (and Europe) Face*, 30 Del. J. Corp. L. 673, 678 (2005). A controlling stockholder occupies a uniquely advantageous position for extracting differential benefits from the corporation at the expense of minority stockholders. *See id.* There is also "an obvious fear that even putatively independent directors may owe or feel a more-than-wholesome allegiance to the interests of the controller, rather than to the corporation and its public stockholders." *** "For that reason, when a controlling stockholder is on the other side of the deal from the corporation, our law has required that the transaction be reviewed for substantive fairness even if the transaction was negotiated by independent directors or approved by the minority stockholders." Strine, *supra*, at 678. The entire fairness framework

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.[587]

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clearly governs squeeze-out mergers, but Delaware courts also have applied it more broadly to transactions in which a controller extracts a non-ratable benefit.

587 *See Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304 (Del. 2015), *affirming 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," Delaware Supreme 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, the 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, and held the merger was not subject to the entire fairness standard of review and the business judgment standard of review was invoked because the merger was approved by a disinterested and informed stockholder majority); *Delaware County Employees Retirement Fund v. Sanchez*, 124 A.3d 1017 (Del. 2015), reversing *In re Sanchez Energy Derivative Litigation*, Consol. C.A. No. 9132-VCG, 2014 WL 6673895 (Del. Ch. Nov. 25, 2014) (Delaware Supreme Court in addressing whether plaintiff had adequately pled that the director who was the swing vote on a five member Board was not independent, and thus that the Board's action was subject to entire fairness review rather than business judgment rule review because the Board was not composed of a majority of independent directors, held that demand was excused and explained: "the plaintiffs pled not only that the director had a close friendship of over half a century with the interested party, but that consistent with that deep friendship, the director's primary employment (and that of his brother) was as an executive of a company over which the interested party had substantial influence; [t]hese, and other facts of a similar nature, when taken together, support an inference that the director could not act independently of the interested party . . . [and] could not consider a [derivative] demand impartially."); *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 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 the *Crimson* 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 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 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

In *Kahn v. Lynch Communication Systems, Inc.* ("Lynch I")[588] 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."[589] 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.[590]

In *Kahn v. M&F Worldwide Corp.*,[591] the Delaware Supreme Court held, in affirming then Chancellor Strine decision in *In re MFW Shareholders Litigation*,[592] 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:

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minority blockholder's power must be 'so potent that independent directors ... cannot freely exercise their judgment, fearing retribution' from the controlling minority blockholder.").

588 638 A.2d 1110, 1117 (Del. 1994).

589 *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.).

590 *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).

591 88 A.3d 635 (Del. 2014). *See* M&A Jurisprudence Subcomm., Mergers and Acquisitions Comm., Am. Bar Ass'n Bus. Law Section, *Annual Survey of Judicial Developments Pertaining to Mergers and Acquisitions*, 70 BUS. LAW. 495, 530–32 (2015).

592 67 A.3d 496 (Del. Ch. 2013); *see* M&A Jurisprudence Subcomm., Mergers & Acquisitions Comm., Am. Bar Ass'n Bus. Law Section, *Annual Survey of Judicial Developments Pertaining to Mergers & Acquisitions*, 69 BUS. LAW. 477, 517–20 (2014).

> [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 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 . . . .
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> . . . [T]he Board shall not approve the Proposal without a prior favorable recommendation of the Special Committee . . . .
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> . . . [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 the case 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 *Kahn v. M&F Worldwide* was subjected to (and failed) entire fairness review in *In re Dole Food Co. Inc. Stockholder Litigation*[593] because the Chancery Court found the transaction complied with *Kahn v. M&F Worldwide* 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 *Kahn v. M&F Worldwide* case, Murdock's offer was conditioned on (i) approval from a special committee of the Board

593 CA No. 8703-VCL (August 27, 2015).

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 *Kahn v. M&F Worldwide* 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 *Kahn v. M&F Worldwide* was not satisfied because Murdock and his right-hand man, Dole's President and General Counsel 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).

Kahn v. M&F Worldwide was applied in the context of a challenge to a consulting agreement between a corporation and its controlling stockholder in *In re EZCORP Inc. Consulting Agreement Derivative Litigation*.[594] The Court of Chancery held that where the corporation did not insulate the questioned transaction through procedural safeguards established up front, before any negotiations began, such as the approval of (a) an effectively functioning committee of independent directors, and (b) a fully informed, non-coerced vote of the unaffiliated shareholders, the court would review it under the "entire fairness" standard of review, and explained:

> If a controller agrees up front, before any negotiations begin, that the controller will not proceed with the proposed transaction without both (i) the affirmative recommendation of a sufficiently authorized board committee composed of independent and disinterested directors and (ii) the affirmative vote of a majority of the shares owned by stockholders who are not affiliated with the controller, then the controller has sufficiently disabled itself such that it no longer stands on both sides of the transaction, thereby making the business judgment rule the operative standard of review. *M & F Worldwide*, 88 A.3d at 644. If a controller agrees to use only one of the protections, or does not agree to both protections up front, then the most that the controller can achieve is a shift in the burden of proof such that the plaintiff challenging the transaction must prove unfairness.[595]

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[594] C.A. No. 9962-VCL (Jan. 25, 2016).

[595] Citing *Americas Mining Corp. v. Theriault*, 51 A.3d 1213 (Del. 2012), *affirming In re Southern Peru Copper Corporation Shareholder Derivative Litigation*, 52 A.3d 761 (Del. Ch. 2011).

(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."[596] 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. Oppression of Minority Shareholders.

2.7.1. 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*,[597] 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.[598]

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.[599] In Delaware, it is generally

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596 567 A.2d 1279, 1286 (Del. 1989) (citing *Mills Acquisition Co.*, 559 A.2d at 1286-88).

597 443 S.W.3d 856 (Tex. 2014).

598 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), *disapproved of by Ritchie v. Rupe*, 443 S.W.3d 856 (Tex. 2014); *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).

599 *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

understood that there is no separate cause of action for minority stockholder oppression,[600] although numerous cases have found that oppressive conduct of a controlling shareholder constitutes a breach of the fiduciary duty of loyalty.[601]

2.7.2. 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.[602] 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. 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.[603] 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.[604]

The Supreme Court also emphasized that common law fiduciary duties, as articulated in *Gearhart Indus., Inc. v. Smith Intern., Inc.*,[605] 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*.

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,"

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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 209-217 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 209-216 and related text.

600 *See infra* note 633 and related text.

601 See infra notes 635-638 and related text.

602 *Ritchie v. Rupe,* 443 S.W.3d 856, 873 (Tex. 2014).

603 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.

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

605 741 F.2d 707, 723–24 (5th Cir. 1984).

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.[606]

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.[607] Whether there exists a personal interest by a director will be a question of fact.[608] 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.[609] 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.[610]

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*, 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

606 *Id*. at 723 n. 9 (noting that the business judgment rule is only a defense to the duty of care).

607 *Gearhart Indus., Inc. v. Smith Int'l*, 741 F.2d 707, 719 (5th Cir. 1984).

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

609 *Id*. at 577 (indicating that good faith conduct requires a showing that the directors had "an intent to confer a benefit to the corporation").

610 *Gearhart*, 741 F.2d at 719-20.

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.[611]

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 TBCA[612] 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 receiver 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.[613] 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.

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

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611 *Ritchie v. Rupe*, 443 S.W.3d at 887.

612 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."

613 TBOC § 11.404.

interested parties."[614] 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.[615]

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 liquidating[616]) 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

614 *Fanning v. Barrington Condominium Assoc., Inc.*, No. 2009-CI-10922, 2010 WL 1984070, at *1 (Tex. App.—San Antonio, Mar. 26, 2010, no pet.).

615 *Hammond v. Hammond*, 216 S.W.2d, 630, 633 (Tex. Civ. App.—Fort Worth 1949, no writ).

616 443 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.[617]

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.
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> * * *
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> 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*.[618]

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

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617 *Ritchie v. Rupe*, 443 S.W.3d at 870.

618 *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.[619] 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.

(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 directors and officers as a source of relief for plaintiffs.[620] 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.[621] 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.[622] 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.[623] As a result, the plaintiff's direct claim for damages was improper.[624] Instead of expanding the notion of shareholder oppression that had been accepted by other Texas Courts of Appeal, the *Faour* court turned to traditional fiduciary duties to provide a remedy for the plaintiff.[625] This case is not alone; instead, Texas courts have frequently shown that oppression cases are properly labeled fiduciary duty cases.[626]

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.[627] However, under TBOC § 21.563, in a corporation with less than thirty-five shareholders, a shareholder may bring a direct fiduciary duty claim.[628] In this case, an individual shareholder plaintiff may

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619 *See supra* note 598 (identifying Texas cases addressing shareholder oppression).

620 *See infra* notes 621-626 and related text (discussing such cases).

621 789 S.W.2d 620, 622 (Tex. App.—Texarkana 1990, writ denied).

622 *Id*.

623 *Id*.

624 *Id*.

625 *Id*.

626 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.*, 367 S.W.3d 355, 365 (Tex. App.—Houston [1st Dist.] 2012, pet. granted, j*udgment set aside and remanded by agreement* (Jan. 11, 2013) *by Devon Energy Holdings v. Allen*, 2013 Tex. LEXIS 20 (Tex., Jan. 11, 2013) (case settled in 2013 while writ of error pending).

627 *Gearhart Indus., Inc. v. Smith Int'l, Inc.*, 741 F.2d 707, 722 (5th Cir. 1984)

628 *See supra* note 419 and related text.

personally recover for the breach of fiduciary duty by a director.[629] This allowance of a direct claim for breach of fiduciary duty challenges traditional notions of to whom fiduciary duties are owed.[630] 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.[631]

2.7.3. Delaware.

(a) Oppression Generally Not Separate Cause of Action in Delaware. Delaware law does not recognize shareholder oppression as a separate cause of action,[632] 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.[633]

(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.[634] Delaware recognizes that a controlling shareholder[635] (or a control group)[636] 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.[637] 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.[638]

In *Blaustein v. Lord Baltimore Capital Corp.*,[639] 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.

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629 TBOC § 21.563(c)(1).

630 Charles Henry Still, *Shareholder Oppression Actions in Texas*, Texas Bar CLE (Oct. 13-14, 2011).

631 Charles Henry Still, *Shareholder Oppression Actions in Texas*, Texas Bar CLE (Oct. 13-14, 2011).

632 *Riblet Products Corp. v. Nagy*, 683 A.2d 37, 37 (Del. 1996).

633 *See Litle v. Waters*, C.A. No. 12155, 1992 WL 25758 (Del. Ch. Feb. 11, 1992); *Garza v. TV Answer, Inc.*, No. 12784, 1993 WL 77186 (Del. Ch. Mar. 11, 1993); *but see Gagliardi v. Trifoods Intl*, 683 A.2d 1049 (Del. Ch. 1996).

634 *See In re Siliconix Inc. Shareholders Litig.*, C.A. No. 18700, 2001 WL 716787 (Del. Ch. June 19, 2001); *In re Ocean Drilling & Exploration Co. Shareholders Litig.*, Del. Ch., Consol. C.A. No. 11898, Chandler, V.C., mem. op. at 6-7 (Apr. 30, 1991).

635 *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 408 and related text.

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

637 *Abraham v. Emerson Radio Corp.*, 901 A.2d 751, 752 (Del. Ch. 2006).

638 *In re CompuCom Sys., Inc. Shareholders Litigation*, Cons. C.A. No. 499-N, 2005 WL 2481325, at *1 (Del. Ch. Sept. 29, 2005).

639 84 A.3d 954 (Del. 2014).

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 any other price. It follows that she has no right to insist on the formation of an independent board committee to negotiate with her.
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> 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. * * *
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> 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.

2.8. Other Corporate Governance Considerations.

2.8.1. 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.*[640]

[640] 938 A.2d 304, 306 (Del. Ch. 2009).

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 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.[641]

Amylin was followed in *Kallick v. SandRidge Energy, Inc.*,[642] 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 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*.[643] 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

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[641] *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).

[642] C.A. No. 8182-CS, 2013 WL 868942 (Del. Ch. Mar. 8, 2013).

[643] C.A. No. 9789-VCL, 2014 WL 6388645 (Del. Ch. Oct. 14, 2014) (TRANSCRIPT)).

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 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.

2.8.2. 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.[644]

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.[645] A business combination is defined under DGCL § 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).[646] 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.[647]

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644 *See* DGCL § 203(c)(8).

645 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 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.

646 DGCL § 203(b).

647 *Id.*

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.[648] 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.[649]

(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.[650] These anti-takeover provisions (i) apply only to an "issuing public corporation"[651] and (ii) prohibit a "business combination"[652] (which includes a merger, share exchange, sale of assets, reclassification, conversion or other transaction between the issuing public corporation and any "affiliated shareholder")[653] 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.[654] 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.[655] 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.

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648 *See In re Digex, Inc. S'holders Litig.*, 789 A.2d 1176, 1179 (Del. Ch. 2000).

649 *Id.*

650 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).

651 "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. TBOC §§ 21.601(1), 21.606; TBCA arts. 13.02(A)(6), 13.03. These TBOC and TBCA 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).

652 TBOC § 21.604.

653 "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.

654 TBOC § 21.606.

655 TBOC § 21.401(b).

2.8.3. 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.[656]

2.8.4. 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 reasonably believes are within that person's professional or expert competence.[657] In Delaware, this reliance must be made in good faith and the selection of outside advisors must have been made with reasonable care.[658] In Texas, reliance must be made both in good faith and with ordinary care.[659]

2.8.5. 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.[660] 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.[661]

2.8.6. Inspection of Records by Shareholders.

Texas. Under TBOC § 21.218, 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.[662] 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."[663]

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. The most 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

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656 TBOC § 21.316; TBCA art. 2.41(A)(1); DGCL § 174(a).

657 *See* TBOC §§ 21.316(c), 3.102; TBCA art. 2.41(D); DGCL § 141(e).

658 DGCL § 141(e); *see also Brehm v. Eisner*, 746 A.2d 244, 248 (Del. 2000).

659 TBOC § 21.316(c)(1); TBCA art. 2.41(D).

660 TBOC § 3.152; TBCA art. 2.44(B); DGCL § 220(d).

661 *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 321; *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 285.

662 *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).

663 *Johnson Ranch Royalty Co. v. Hickey*, 31 S.W.2d 150, 153 (Tex. App.—Amarillo 1930, writ ref'd).

as a stockholder."[664] Proper purpose is usually defined broadly by the Delaware courts, with a few exceptions.

2.8.7. 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.[665] The liability is only for 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.[666] 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.[667] 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.[668]

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664 8 Del. C. § 220(b).

665 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 corporation is not affected by the revival of the charter or certificate and the corporate privileges.

666 *Rossmann v. Bishop Colorado Retail Plaza, L.P.,* 455 S.W.3d 797, 802-804 (Tex, App.—Dallas 2015).

667 *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.).

668 *Taylor v. First Cmty. Credit Union*, 316 S.W.3d 863, 864 (Tex. App.—Houston [14th Dist.] 2010, no pet.).

2.8.8. 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 authority[669] and may be express or implied.[670] Ratification by the principal of its agent's act relates back to the time of the act.[671] 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.[672] 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.[673] The defendant corporation's executive committee initiated condemnation proceedings against the plaintiff before the defendant corporation's Board passed a resolution authorizing such action.[674] 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 actions of the executive committee because it could have authorized them initially.[675] As a result, the timing of the Board's resolution was not problematic and the defendant corporation's actions were permissible.[676]

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.[677]

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669 RESTATEMENT (THIRD) OF AGENCY: RATIFICATION DEFINED § 4.01 (2006).

670 *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).

671 *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.)).

672 *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)).

673 351 S.W.3d at 90.

674 *Id.*

675 *Id.*

676 *Id.*

677 *Id.* cmt. c.

Ratification is effective, however, only when there has been full disclosure of the material facts to the shareholders.[678]

Effective September 1, 2015, the TBOC was amended to add a new Subchapter R[679] to supplement the common law of ratification by Board or shareholder action discussed above by establishing specific non-exclusive[680] 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.[681]

(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,[682] 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.[683] 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.[684] 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

678 *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)); s*ee 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).

679 TBOC §§ 21.901 – 21.917.

680 TBOC § 21.913.

681 See *infra* notes 1212-1218.

682 *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).

683 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).

684 *Id.*

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.[685] 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"[686] and to "[m]ake such other orders regarding such matters as it deems proper under the circumstances."[687] 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."[688]

2.9. <u>Dissent and Appraisal Rights</u>. The corporation statutes of each state contain provisions permitting shareholders to dissent from certain corporate actions and to seek a court directed appraisal of their shares under certain circumstances by following specified procedures.[689] The principal purpose of these provisions is to protect the rights of minority shareholders who object to a fundamental corporate action which the majority approves.[690] The fundamental corporate actions covered vary from state to state, but generally include mergers and in some states conversions, statutory share exchanges and sales of all or substantially all of the assets of the corporation.[691]

2.9.1. <u>Texas Corporate Statutes</u>.

(a) <u>When Texas Statutory Appraisal Rights Are Triggered</u>. Under the Texas Corporate Statutes and subject to certain limitations, a shareholder of a Texas corporation has the right to dissent from any of the following corporate actions: a merger, a statutory share exchange or the sale of all or substantially all of the corporation's assets other than in the usual and regular course of business;[692] <u>provided</u> that shareholder approval of the corporate action is required and the shareholder holds shares of a class or series entitled to vote on the corporate action.[693] The purpose of the dissenters' rights provisions of the Texas Corporate Statutes is to provide

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685 *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 678 and related text.

686 DGCL § 205(b)(8).

687 DGCL § 205(b)(10).

688 DGCL § 204(h)(1).

689 *See* Christian J. Henrick, *Game Theory and Gonsalves: A Recommendation for Reforming Stockholder Appraisal Actions*, 56 Bus. Law. 697 (2001).

690 *Id.*

691 *See* Stephen H. Schulman & Alan Schenk, *Shareholders' Voting and Appraisal Rights in Corporate Acquisition Transactions*, 38 BUS. LAW. 1529 (1983).

692 The Texas Corporate Statutes provide that an asset transaction is in the "usual and regular course of business" of the corporation if thereafter the corporation shall, directly or indirectly, either continue to engage in one or more businesses or apply a portion of the consideration received in connection with the transaction in the conduct of a business in which it engages following the transaction. TBOC § 10.354; TBCA art. 5.09(B).

693 TBOC § 10.354; TBCA art. 5.11(A).

shareholders with the opportunity to choose whether to sell their shares at a fair price (as determined by a court) or to be bound by the terms of the corporate action.[694]

(b) Who Is Entitled to Texas Statutory Appraisal Rights. The Texas Corporate Statutes provide that a shareholder does not have the right to dissent from a plan of merger or exchange in which there is a single surviving or new domestic or foreign corporation, if:

(i) The shares held by the shareholder are part of a class or series, shares of which are on the record date fixed to determine the shareholders entitled to vote on the plan of merger or exchange (a) listed on a national securities exchange; (b) listed on the NASDAQ Stock Market (or successor quotation system) or designated as a national market security on an interdealer quotation system by the National Association of Securities Dealers, Inc., or successor entity; or (c) held of record by not less than 2,000 holders;

(ii) The shareholder is not required by the terms of the plan of merger or exchange to accept for the shareholder's shares any consideration that is different than the consideration (other than cash in lieu of fractional shares that the shareholder would otherwise be entitled to receive) to be provided to any other holder of shares of the same class or series of shares held by the shareholder; and

(iii) The shareholder is not required by the terms of the plan of merger or exchange to accept for the shareholder's shares any consideration other than (a) shares of a corporation that, immediately after the effective time of the merger or exchange, will be part of a class or series, shares of which are listed, or authorized for listing upon official notice of issuance, on a national securities exchange, approved for quotation as a national market security on an interdealer quotation system, or held of record by not less than 2,000 holders; (b) cash in lieu of fractional shares otherwise entitled to be received; or (c) any combination of securities and cash in lieu of fractional shares.[695]

One reason for denying dissenters' rights under these circumstances is that the shareholders are able to liquidate their investment for fair value in the public market.[696]

(c) Procedural Aspects of Texas Statutory Appraisal. A shareholder wishing to object to a merger or exchange may do so only by complying with the relevant statutory procedures.[697] Unless there is fraud in the transaction, no other remedies are available to recover the value of shares or damages with respect to the objectionable action.[698] A shareholder who

694 *See generally Massey v. Farnsworth*, 353 S.W.2d 262, 267-68 (Tex. Civ. App.—Houston 1961), *rev'd on other grounds*, 365 S.W.2d 1 (Tex. 1963).

695 TBOC § 10.354(b); TBCA art. 5.11.B.

696 *See* Robert F. Gray, Jr., *Annual Survey of Texas Law Part I: Corporations*, 44 Sw. L.J. 225, 232 (1990).

697 TBOC § 10.356; TBCA art. 5.12.

698 TBOC § 10.368; TBCA art. 5.12(G).

fails to comply with the statutory dissent procedure is deemed to have approved the terms of the merger.[699]

2.9.2. Delaware Corporate Statutes. DGCL § 262 provides dissenters rights for shareholders who oppose merger trnasactions that are similar to those provided by the TBOC.

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.[700] 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.[701] 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.[702] 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.

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.[703]

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.[704] 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.[705] 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

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699 TBOC §§ 10.356, 10.368; TBCA arts. 5.12(A), 5.12(G); *see also Hochberg v. Schick Inv. Co.*, 469 S.W.2d 474, 476 (Tex. Civ. App.—Fort Worth 1971, no writ); *see Farnsworth v. Massey*, 365 S.W.2d 1, 3-5 (Tex. 1963).

700 *See* TBOC § 21.213; TBCA art. 2.22(C).

701 TBOC § 21.211; TBCA arts. 2.22(D), (H).

702 TBOC §§ 21.210, 21.213; TBCA arts. 2.22(B), (C).

703 *See infra* notes 995-998 and related text.

704 TBOC § 21.201.

705 TBOC § 21.201(b)-(d) as added in the 2009 Legislative Session by 2009 S.B. 1442 § 33.

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.[706] 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.[707] 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.

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.[708] 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

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706 TBOC § 10.154(c) and TBOC § 10.361(g) as added in the 2009 Legislative Session by 2009 S.B. 1442 §§ 18 and 19.

707 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.

708 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."

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.[709] 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 TBOC Chapter 9 and TBCA Part Eight and subject to taxation by those states. Over the years, there has evolved a substantial body of law for analyzing these questions.[710]

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"),[711] (4) the Texas Revised Limited Partnership Act ("TRLPA")[712] or (5) under a statute of another jurisdiction which is comparable to any of the Texas statutes referred to in (1), (2), (3), or (4) above.[713] 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.[714] 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.[715] 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."[716] Texas general partnerships formed on or after January 1, 2006 had to be governed by the TBOC, and those

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709 TBOC § 3.003.

710 *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.

711 *See* statutes cites *supra* note 2.

712 Tex. Rev. Civ. Stat. Ann. art. 6132a-1 (Vernon Supp. 2010).

713 TBOC § 152.051(c); TRPA § 2.02.

714 TBOC § 152.051(b); TRLPA § 6(a)(1); TRPA § 2.02(a).

715 TBOC §§ 402.001 and 402.005.

716 TBOC § 1.008(f).

formed before January 1, 2006 could voluntarily opt in to TBOC governance between January 1, 2006 and January 1, 2010.[717] Until January 1, 2010 (at which time *all* partnerships became subject to the TBOC),[718] Texas general partnerships which were formed prior to January 1, 2006 and did not opt into the TBOC were governed by the TRPA.[719] 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."[720]

3.1.2. Factors Indicating Partnership. Under the Tex. GP Stats., the following five factors indicate that persons have created a partnership:[721]

- Receipt or right to receive a share of profits;
- 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*,[722] 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

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717 TBOC §§ 402.001 and 402.003.

718 TBOC § 402.005.

719 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).

720 TBOC § 1.002(69-b).

721 TBOC § 152.052(a); TRPA § 2.03(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).

722 288 S.W.3d 886, 895-96 (Tex. 2009).

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.[723]

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:[724]

- 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.[725]

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723 288 S.W.3d at 903-904 (Tex. 2009).

724 TBOC § 152.052(b); TRPA § 2.03(b).

725 The statement in TBOC § 152.052(b)(4) and TRPA § 2.03(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.
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> * * *
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> 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

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."[726]

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."[727] 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.[728] 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.[729]

> 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.

726 *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)).

727 TBOC § 152.051(b); TRPA § 2.02.

728 *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).

729 *See supra* note 110 regarding *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," in which the court 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.

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*.[730] They also resolve old questions about whether an agreement to share losses was necessary to create a partnership by providing that it is unnecessary.[731]

3.2. <u>Formation and Governing Documents</u>. 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 of an association of two or more persons carrying on, as co-owners, a business for profit.[732] The factors discussed above. are used to determine whether or not a general partnership exists.[733] Thus, it is not necessary that any written partnership agreement exists or that any significant expenses be incurred in the formation of a partnership.[734] 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.[735] 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.[736] 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.[737]

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

730 *See Coastal Plains Dev. Corp. v. Micrea, Inc.*, 572 S.W.2d 285, 287–88 (Tex. 1978).

731 TBOC § 152.052(c); TRPA § 2.03(c).

732 TBOC § 152.051; TRPA § 2.02(a).

733 TBOC § 152.052(a); TRPA § 2.03(a); *see supra* notes 721-725 and related text.

734 *See Pappas v. Gounaris*, 301 S.W.2d 249, 254 (Tex. Civ. App.—Galveston 1957, writ ref'd n.r.e.).

735 TBOC § 152.002(a); TRPA § 1.03(a).

736 TBOC § 152.002(b); TRPA § 1.03(b).

737 *See* TBOC § 152.202(c); TRPA § 4.01(b).

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.,[738] 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.[739] Provisions in a partnership agreement that serve to allocate liability among the partners are generally ineffective against third-party creditors.[740] 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.[741]

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.[742]

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.[743] 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.[744]

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

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738 TBOC § 152.303; TRPA § 3.03.

739 TBOC § 152.304; TRPA § 3.04.

740 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).

741 TBOC §§ 152.203(d), 152.708; TRPA §§ 4.01(c), 8.06(c).

742 TBOC § 152.304(b); TRPA § 3.07.

743 TRPA § 6.02(c).

744 *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).

joint and several liability, except in limited circumstances.[745] Previously, a creditor could obtain a judgment enforceable against an individual partner's assets without suing the partnership.[746] 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.[747]

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.

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.[748] 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 partnerships[749] and LLCs.[750]

3.4. <u>Management</u>. 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.[751] 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.[752] 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 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.[753]

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745 TBOC § 152.306; TRPA § 3.05.

746 *See* statues cited *supra* note 2.

747 TBOC § 152.306(a); TRPA § 3.05(c).

748 TBOC § 152.308.

749 TBOC § 153.256; *see* note 808 and related text.

750 TBOC § 101.112; *see* note 1001 and related text.

751 TBOC § 152.203(a); TRPA § 4.01(d).

752 TBOC §§ 152.301, 152.302; TRPA § 3.02.

753 TBOC §§ 152.210, 152.302; TRPA § 4.05.

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.[754] These duties are fiduciary in nature although not so labeled.[755]

3.5.2. Loyalty. The duty of loyalty requires a general partner to place the interests of the partnership ahead of his own interests.[756] 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.[757]

3.5.3. Care. The duty of care requires a partner to act as an ordinarily prudent person would act under similar circumstances.[758] A partner is presumed to satisfy the duty of care if the partner

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754 TBOC § 152.204; TRPA § 4.04.

755 *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).

756 *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.

757 *See* TBOC § 152.205; TRPA § 4.04(b); *Bromberg & Ribstein*, *supra* note 728, at § 6.07.

758 TBOC § 152.206(a); TRPA § 4.04(c).

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.[759]

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.[760]

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.[761] 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,[762] which represents a change from cases under TUPA.[763] A managing partner stands in a higher fiduciary relationship to other partners than partners typically occupy.[764]

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.[765] 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.[766]

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 another without going through a merger or transfer of assets.[767] Article IX of the TRPA and chapter 10 of the TBOC include provisions relating to the mechanics of adopting a plan of

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759 TBOC §§ 152.204(b), 152.206(c); TRPA §§ 4.04(c), (d).

760 *Bromberg & Ribstein*, *supra* note 728, at §§ 6.05(c) and 6.06.

761 TBOC § 152.210; TRPA § 4.05.

762 TBOC § 152.204(d); TRPA § 4.04(f).

763 *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).

764 *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.

765 TBOC § 152.002; TRPA § 1.03(b); *see infra* notes 735-736 and related text.

766 *See supra* notes 451-455 and *infra* notes 735-736 and related text.

767 TBOC Chapter 10; TRPA §§ 9.01-9.06.

merger or conversion, obtaining owner approval, filing with the Secretary of State and protecting creditors.[768]

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 a 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.[769] 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.[770] 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.[771] 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.[772] General partnership interests may be evidenced by transferable certificates, but ordinarily no such certificates are issued.[773]

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."[774] 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.[775] The 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*,

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768 *Id.*; TBOC §§ 10.001-10.009; 10.101-10.151; 10.154-10.201.

769 *See* TBOC §§ 152.401, 152.402(3); TRPA § 5.03.

770 *See* TBOC §§ 152.402(3), 152.404(a), (c); TRPA §§ 5.02, 5.03 and 5.04.

771 TBOC §§ 152.402(1), (2); TRPA § 5.03(a).

772 TBOC § 152.201; TRPA § 4.01(g).

773 TBOC § 3.201; TRPA § 5.02(b).

774 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).

775 *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).

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).

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.[776] The statutes provide for "events of withdrawal" and "events of winding up."[777] Upon the occurrence of an event of withdrawal, the business of the partnership is not required to be wound up.[778] 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.[779] Except for the partner's right to withdraw, most of the statutory events of withdrawal may be modified by the partnership agreement,[780] 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.[781] Unless the partnership agreement provides otherwise,[782] the interest of a withdrawing partner (except for a partner who wrongfully withdraws) must be redeemed by the partnership at fair market value.[783] 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.[784]

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.[785]

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776 TBOC §§ 152.502, 152.701; TRPA §§ 2.06(a), 8.02.

777 TBOC §§ 11.051, 11.057, 152.501(b); TRPA §§ 1.01(6), (7); 6.01(b), 8.01.

778 TBOC § 152.502; TRPA § 2.06(a).

779 TBOC § 152.501(b); TRPA § 6.01.

780 TBOC § 152.002; TRPA § 1.03.

781 TBOC § 152.503; TRPA § 6.02.

782 TBOC § 152.002; TRPA § 1.03.

783 TBOC §§ 152.601-152.602; TRPA § 7.01. In the case of a partner who wrongfully withdraws, the redemption price is the lesser of fair market value or liquidation value. TBOC §§ 152.601-152.602; TRPA § 7.01.

784 TBOC §§ 11.051, 11.057; TRPA § 8.01.

785 *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).

CHAPTER 4. LIMITED PARTNERSHIP.

4.1. <u>General</u>. A "<u>limited partnership</u>" is a partnership formed by two or more persons, with one or more general partners and one or more limited partners.[786] 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.[787] Like other entities formed under Texas law, limited partnerships formed on or after January 1, 2006 are governed by the TBOC,[788] 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.[789] 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 "<u>Tex. LP Stats.</u>" 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.

4.2. <u>Formation and Governing Documents</u>. 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.[790] Additionally, a filing fee of $750 must be paid upon filing the certificate of formation.[791]

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.[792]

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786 TBOC § 1.002(50); TRLPA § 1.02(6).

787 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).

788 TBOC § 401.001.

789 TBOC § 402.005; TRLPA § 13.10.

790 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).

791 TBOC § 4.155(1).

792 *See* TBOC §§ 152.002, 153.003; TRPA § 1.03.

The Tex. LP Stats. assume the existence of a limited partnership agreement, but allow the agreement to be either written or oral.[793] An oral limited partnership agreement is subject to the statute of frauds.[794]

The name of the limited partnership must contain the word "limited," the phrase "limited partnership," or an abbreviation of either.[795]

Unless the partnership agreement provides otherwise, unanimity is required to amend a limited partnership agreement.[796] 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 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. <u>Owner Liability Issues</u>. A general partner of a limited partnership has the same unlimited liability as does a partner of a general partnership.[797] The Tex. LP Stats. authorize a limited partnership to register as an LLP by complying with the LLP provisions of TBOC or TRPA discussed below, whereupon the general partner would be liable for the debts or

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793 TBOC § 151.001(5); TRLPA § 1.02(10).

794 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).

795 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.

796 TBOC § 152.208; TRPA § 4.01(i).

797 *See* TBOC § 153.152; TRLPA §§ 4.01(d), 4.03(a). *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."

obligations of the limited partnership only to the extent provided in TBOC § 152.801 or TRPA § 3.08(a) and the limited partnership would be an "LLLP."[798]

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).[799] Veil piercing is inapplicable to Texas limited partnerships.[800] A limited partner may lose this limited liability, however, if he or she participates in the management of partnership business.[801] 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.[802]

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.[803] Under the TRLPA, though not under the TBOC, a limited partner who knowingly permits his name to be

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798 TBOC §§ 152.805, 153.351, 153.353; TRPA § 3.08(e); TRLPA § 2.14. *See infra* notes 1109-1114 and related text.

799 *See* TBOC § 153.102; TRLPA § 3.03. 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).

800 *See Asshauer v. Wells Fargo Foothill*, 263 S.W.3d 468, 474 (Tex. App.—Dallas 2008, pet. denied). As such, TBOC § 21.223 and TBCA art. 2.21 make no mention of limited partners; neither the TBOC nor the TRLPA makes any effort to incorporate TBOC § 21.223 or TBCA art. 2.21 by reference; and neither the TBOC nor the TRLPA 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 TBOC § 21.223 or 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 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.

801 *Id.*

802 TBOC § 153.103; TRLPA § 3.03(b).

803 TBOC § 153.102(b); TRLPA § 3.03(a).

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.[804] 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.[805]

4.4. <u>Distributions</u>. 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.[806] 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.[807]

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.[808] 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 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 partnerships[809] and LLCs.[810]

4.5. <u>Management</u>. 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.[811] 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.[812] Under Tex. LP Stats., the partnership agreement may provide for multiple classes

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804 TRLPA § 3.03(d); Revisor's Note to TBOC § 153.102.

805 *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).

806 TBOC § 153.210(a).

807 TBOC § 153.210(b).

808 TBOC § 153.256.

809 TBOC § 152.308; *see supra* note 748 and related text.

810 TBOC § 101.112; *see infra* note 1001 and related text.

811 TBOC § 153.152; TRLPA § 4.03(a).

812 TBOC §§ 153.102, 153.103; TRLPA § 3.03.

or groups of limited partners having various rights or duties, including voting rights.[813] A limited partnership may have elected or appointed officers (but not directors).[814]

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 cases.[815] Because of their control over partnership affairs, general partners may be subjected to an even higher fiduciary standard with respect to limited partners.[816] Those in control of the general partner have been held to the same high standards.[817]

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 TBOC section 152.204 and TRPA section 4.04,[818] which basically codify those duties without

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813 TBOC § 154.101; TRLPA § 3.02.

814 TBOC § 151.004.

815 *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.).

816 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]."

817 *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").

818 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

giving them the "fiduciary" appellation.[819] Since Tex. LP Stats. provide that a general partner's 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.[820] Courts, however, continue to refer to the trustee standard.[821]

A general partner in a limited partnership owes the duties of care and loyalty to the partnership and the other partners.[822] 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.[823] An error in judgment does not by itself constitute a breach of the duty of care.[824] 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.[825] 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.[826]

> (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.

819 TBOC §§ 153.003, 153.152; TRLPA §§ 4.03(b), 13.03. TBOC § 153.152 provides:

> 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).

820 TBOC § 152.204(d); TRPA § 4.04(f).

821 *See McBeth v. Carpenter*, 565 F.3d 171 (5th Cir. 2009); *Hughes v. St. David's Support Corp.,* 944 S.W.2d 423, 425-26 (Tex. App.—Austin 1997, writ denied).

822 TBOC § 152.204(a); TRPA § 4.04(a).

823 TBOC § 152.206(a); TRPA § 4.04(c).

824 TBOC § 152.206(a); TRPA § 4.04(c).

825 TBOC §§ 152.204(b), 152.206; TRPA § 4.04(c)-(d).

826 *See Ferguson v. Williams*, 670 S.W.2d 327, 331 (Tex. App.—Austin 1984, writ ref'd n.r.e.).

In Texas, the duty of loyalty is defined as including:[827]

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

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).[828] 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.[829] 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.[830]

Under the TBOC *limited* partners, as limited partners, generally do not owe fiduciary duties to the partnership or to other partners.[831]

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."[832]

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827 TBOC § 152.205; TRPA § 4.04(b).

828 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); s*ee 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.).

829 TBOC § 152.204(c)-(d); TRPA § 4.04(e)-(f).

830 TBOC § 152.204(b); TRPA § 4.04(d).

831 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").

832 TBOC § 153.152(a); TRLPA § 4.03(b). This language should *not* be mistaken as an authorization for partnership agreements to alter partner liabilities to third parties. *See infra* notes1061-1134 and related text regarding the LLP provisions in the TBOC and TRPA 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

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,[833] in *Strebel v. Wimberly II*[834] 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."[835]

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.[836] 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."[837] In one case decided prior to the passage of the TRPA or 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.[838]

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

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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 938.

833 *See* TBOC § 152.002(b); TRPA § 1.03(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* TBOC § 151.001(5); TRLPA § 1.02(10) (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* TBOC § 153.152 and TRLPA § 4.03(a) concerning restrictions on a general partner *with* TRLPA § 11.02 and TBOC § 8.103(c) concerning indemnification of a general partner.

834 371 S.W.3d 267 (Tex. App.—Houston [1st Dist.] 2012, pet. denied).

835 See supra note 766 and related text

836 TBOC §§ 152.002(b); 153.003(a); TRLPA §§ 4.03(b), 13.03(a); TRPA §§ 1.03(b), 4.04.

837 TBOC § 152.002(b)(3); TRLPA §§ 4.03(b), 13.03(a); TRPA §§ 1.03(b)(3), 4.04.

838 *Grider v. Boston Co., Inc.*, 773 S.W.2d 338, 343 (Tex. App.—Dallas 1989, writ denied).

activities that do not violate the duty of loyalty, again if not "manifestly unreasonable."[839] 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."[840] 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.[841] 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 broader fiduciary duty of candor regarding partnership affairs as developed in case law and as provided in Tex. LP Stats.[842]

4.6.2. Delaware. Delaware concepts of general partner fiduciary duties generally parallel Texas law, and are framed in the Delaware statutes.[843] 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.[844] Although limitations on fiduciary 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."[845]

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.[846]

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839 TBOC §§ 152.002(b)(2), 153.003(a); TRLPA §§ 4.03(b), 13.03(a); TRPA §§ 1.03(b)(2), 4.04.

840 TBOC §§ 152.002(b)(4), 153.003(a); TRLPA §§ 4.03(b), 13.03(a); TRPA §§ 1.03(b)(4), 4.04.

841 TBOC §§ 153.551, 153.552; TRLPA § 1.07.

842 *See* TBOC §§ 153.551, 153.552; TRPA § 4.03.

843 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 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.

844 DRLPA §§ 17-1101(b)-(f).

845 *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.).

846 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*

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.[847] 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 for challenging an unfair M&A transaction even where default fiduciary duties have been clearly eliminated in the LPA.[848] 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.[849]

A corporation that controls the general partner may owe a duty of loyalty to the limited partnership.[850] 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.[851] 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.[852]

4.7. <u>Business Combinations</u>. 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.[853] The Tex. LP Stats. have provisions

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Annuity and Benefit Fund of Chicago, No. 547, 2012, 2013 WL 4517001 (Del. Aug. 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).

847 "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.

848 *Gerber v. Enter. Prods. Hldgs., LLC*, 67 A.3d 400, 404 (Del. June 10, 2013).

849 *In re El Paso Pipeline Partners, L.P. Derivative Litigation*, C.A. No. 7141-VCL (Del. Ch. Apr. 20, 2015).

850 *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.").

851 *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).

852 *Cargill, Inc. v. JWH Special Circumstance LLC*, 959 A.2d 1096 (Del. Ch. 2008).

853 TBOC § 10.001; TRLPA §§ 2.11, 2.15. 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

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 TBOC § 21.455 and the parallel TBCA provisions which require shareholder approval of sales of all or substantially all of a corporation's assets in certain circumstances.[854] 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.[855] 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.[856] 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.[857] 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.[858] General partners may only be indemnified to the extent consistent with the statute.[859] 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.[860] Insurance providing coverage for unindemnifiable areas is expressly permitted.[861]

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

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approval. *See* TBOC § 10.009(f); TRLPA §§ 2.11(a)(1), 2.11(a)(2), 2.11(d)(1)(F), 2.15(a)(1). 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.

854 *See supra* notes 88-89 and related text regarding the requirements of TBOC § 21.455 and the parallel TBCA arts. 5.09 and 5.10 provisions.

855 TBOC §§ 8.003, 8.051; TRLPA §§ 11.08, 11.21.

856 TBOC § 8.102(b); TRLPA §§ 11.03, 11.05.

857 TBOC § 8.101(a); TRLPA § 11.02.

858 TBOC § 8.102(b); TRLPA §§ 11.03, 11.05.

859 TBOC § 8.004; TRLPA § 11.13.

860 TBOC § 8.105; TRLPA §§ 11.15, 11.17.

861 TBOC § 8.151; TRLPA § 11.18.

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.[862] However, a conditional contribution obligation, including a contribution payable upon a discretionary call prior to the time the call occurs, may not be enforced until all conditions have been satisfied or waived.[863]

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 partnership[864] 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.[865]

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.[866] 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.[867]

4.10. <u>Transferability of Ownership Interests</u>. 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.[868] 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.[869] Instead, the assignment will entitle the assignee to an allocation of income, gain, loss, deductions, credits or similar items and to receive

862 TBOC § 153.201; TRLPA § 5.01.

863 TBOC § 153.202; TRLPA § 5.02(d).

864 TBOC § 153.152; TRLPA §§ 4.01(d), 4.03(b).

865 TBOC § 153.151(c), (d); TRLPA § 4.01(c).

866 *See* TBOC § 153.206; TRLPA § 5.03.

867 *See* TBOC § 153.208; TRLPA § 5.04.

868 TBOC § 153.251; TRLPA § 7.02.

869 TBOC § 153.251(b)(2); TRLPA § 7.02(a)(2).

distributions to which the assignor was entitled.[870] 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.[871] Until an assignee of a partnership interest becomes a partner, the assignee has no liability as a partner solely by reason of the assignment.[872]

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.[873]

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.[874] A limited partnership is required to commence winding up under the TBOC, or was dissolved under TRLPA, 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)[875] absent certain circumstances[876] 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.[877]

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.[878] However, upon the withdrawal of a general partner (unless the

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870 TBOC § 153.251(b)(3); TRLPA § 7.02(a)(3).

871 TBOC § 153.252(b); TRLPA § 7.02(a)(4).

872 TBOC § 153.254(a); TRLPA § 7.02(b).

873 *See infra* notes 995-998 and related text.

874 TBOC §§ 11.051, 11.058; TRLPA §§ 8.01, 8.02.

875 TBOC § 153.155; TRLPA § 4.02.

876 Under TBOC § 153.155(b) and TRLPA § 6.02, 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. TBOC § 153.110 and TRLPA § 6.03 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.

877 TBOC §§ 11.051, 11.314; TRLPA § 8.02.

878 TBOC § 11.052; TRLPA § 8.04.

limited partnership agreement otherwise provides),[879] 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 specified period after the occurrence of the dissolution event and agree to the appointment, if necessary, of one or more new general partners.[880]

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. <u>Operations in Other Jurisdictions</u>. 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.[881] 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.

CHAPTER 5. LIMITED LIABILITY COMPANY.

5.1. <u>General</u>. LLCs formed under Texas law are now governed by Title 3 and pertinent provisions of Title 1 of the TBOC.[882] Because until January 1, 2010 some LLCs were governed by the LLC Act[883] and others by the TBOC and because the substantive principles under both

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879 TBOC §§ 11.051(4), 11.058(b); TRLPA § 8.01(3).

880 TBOC §§ 11.051(4), 11.058(2), 11.152(a), 153.501(b); TRLPA § 8.01. Under the TBOC, such agreement must be made within a year; under the TRLPA, it must be made within ninety days. 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.

881 *See generally* TBOC title 1, chapter 9; *see* TRLPA article 9.

882 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).

883 The Texas Limited Liability Company Act, as amended, is found at TEX. REV. CIV. STAT. ANN. art. 1528n (Vernon Supp. 2011) (hereinafter "<u>LLC Act</u>"). 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 "<u>1991 Bill Analysis Summary</u>"]; TEX.

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.[884]

"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."[885] 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,"[886] and are analogous to shareholders in a corporation or limited partners of a limited partnership.[887] 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.[888] 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,[889] 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.[890] Under the Tex. LLC Stats., any "person" may become a Member or Manager.[891] 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.[892] 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.

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).

884 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).

885 *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)

886 TBOC §§ 1.002(53), 101.101, 101.102; LLC Act § 4.01.

887 1991 Bill Analysis Summary at 41.

888 *See* TBOC § 101.302; LLC Act § 2.13; 1991 Bill Analysis Summary at 41.

889 TBOC §§ 1.002(35), 101.251; LLC Act § 2.12.

890 1991 Bill Analysis Summary at 41.

891 TBOC § 101.102(a); LLC Act § 4.01C.

892 "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).

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.[893] An LLC is subject to Texas Margin Tax.[894]

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.[895] 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.[896]

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.[897] 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.[898] 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.[899] 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.[900]

Under Texas law, an LLC may generally be formed to conduct any lawful business, subject to limitations of other statutes which regulate particular businesses.[901] It has all of the

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893 *See infra* Appendix A – Federal Taxation of Entities.

894 *See infra* 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).

895 *See* Robert R. Keatinge, *New Gang in Town - Limited Liability Companies: An Introduction*, 4 BUS. L. TODAY 5 (Mar./Apr. 1995).

896 *See* Robert F. Gray *et al.*, *Corporations*, 45 Sw.L.J. 1525, 1537 (1992).

897 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.

898 TBOC §§ 3.005, 3.010, 3.014.

899 TBOC §§ 4.051, 4.052.

900 TBOC § 3.006(b).

901 LLC Act § 2.01 provides as follows:

powers of a Texas corporation or limited partnership, subject to any restrictions imposed by statute or its governing documents.[902]

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," "limited company," or an abbreviation of either phrase.[903] 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.[904] 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.[905]

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.[906] Any such amendment must include a statement that it was approved in accordance with the proper provisions of governing laws,[907] or for entities governed by the LLC Act, alternately as provided in the articles of organization or Regulations, along with the date of approval.[908]

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

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> 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.").

902 Governing documents, as used here, includes an LLC's Articles of Organization, Certificate of Formation, Regulations, or Company Agreement. *See* TBOC § 101.402; LLC Act § 2.02.

903 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).

904 TBOC § 5.053.

905 *Id.*

906 TBOC §§ 101.356(d), 101.051, 101.052; LLC Act § 2.23H. 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.

907 TBOC § 3.053(4); LLC Act § 3.06(3).

908 LLC Act § 3.06(3).

those in limited partnership agreements and corporate bylaws.[909] 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").[910] A Company Agreement may be oral or in writing,[911] but an oral Company Agreement is subject to the statute of frauds.[912] The 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.[913] For example, the TBOC provides that the Company Agreement or certificate of

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909 TBOC § 101.052; LLC Act § 2.09A; 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).

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

911 TBOC § 101.001(1); DLLCA § 18-101(7).

912 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 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).

913 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 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.

formation may only be amended by unanimous member consent,[914] but if either document provides otherwise (such as for amendment by manager consent), then it may be amended pursuant to its own terms.[915] The only statutory provisions not subject to contrary agreement are enumerated in TBOC section 101.054.[916]

Although the Company Agreement will ordinarily contain the capital account and other financial and tax provisions found in a typical limited partnership agreement,[917] 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.[918] 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.[919]

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.[920] 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.[921]

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."[922]

5.3. <u>Management</u>. 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.[923] 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.[924] The certification of formation or the Company Agreement,

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914 TBOC §§ 101.053, 101.356(d).

915 *See* TBOC §§ 101.052, 101.054.

916 *See supra* note 913.

917 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. TBOC §§ 3.151, 101.203, 101.501; LLC Act §§ 2.22, 5.01-1, 5.03.

918 The agreement to be contractually bound could be through signing the Company Agreement directly or indirectly through a subscription agreement or power of attorney.

919 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).

920 TBOC § 101.107.

921 TBOC § 101.205.

922 *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").

923 TBOC §§ 101.251-101.253; LLC Act §§ 2.12, 2.21.

924 TBOC § 101.302; LLC Act §§ 2.12, 1.02(4); TEX. GOV'T CODE § 311.005(2).

however, may provide that the management of the business and affairs of the LLC may be reserved to its Members.[925] 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.[926] 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).[927] 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 TBOC section 101.254(a) or LLC Act section 2.21C 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.[928] 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.[929]

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.[930] If the Company Agreement is silent as to the terms of 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.[931]

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[925] *See* TBOC § 101.251; LLC Act § 2.12.

[926] 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.

[927] TBOC §§ 1.002(35), (37), 101.254(a); LLC Act § 2.21C.

[928] TBOC § 101.254(b); LLC Act § 2.21D.

[929] *See Water, Waste & Land, Inc. v. Lanham*, 955 P.2d 997, 1001 (Colo. 1998).

[930] *See* TBOC § 101.303.

[931] *See* TBOC § 101.307; LLC Act § 2.14.

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,[932] 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.[933]

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[932] *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).

[933] 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;
>
> (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

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.[934]

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.[935] 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 LLC will likely be determined by reference to corporate principles in the absence of controlling provisions in the certificate of formation or Company Agreement.[936]

> 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.

934 *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.").

935 *See supra* notes 218-274 and related text.

936 *See Allen v. Devon Energy Holdings, L.L.C.*, 367 S.W.3d 355, 391-97 (Tex. App.—Houston [1st Dist.] 2012, pet. 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) (case settled in 2013 while writ of error pending) (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

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.[937] 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.[938] Unlike the DLLCA which allows an LLC agreement to eliminate fiduciary duties (but not the contractual duty of good faith and fair dealing),[939] the Tex. LLC Stats. only permit an LLC Company Agreement to "restrict" duties, but allow the elimination of liability for breach of fiduciary duties (other than the duty of loyalty).[940]

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,

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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.*, No. 05-99-00213-CV, 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).

937 *See* TBOC § 101.401; LLC Act § 2.20B. 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 933.

938 DEL. CODE ANN. tit. 6, §§ 18-1101(a)-(f) (2013).

939 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 (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 933 and related text.

940 *See supra* note 933 and related text.

but does not allow the elimination of liabilities for breaches of the duty of loyalty or acts or omissions not in good faith.[941]

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.[942]

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 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

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941 *See supra* note 933 and related text.

942 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.

(iii) The transaction is fair to the LLC as of the time it is authorized, approved or ratified by the Managers or Members.[943]

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.[944]

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,[945] although not all Delaware LLC agreements effectively do so.[946] In *Auriga Capital Corp. v. Gatz Properties, LLC*,[947] 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

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943 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; LLC Act § 2.17.

944 *Id.*; *see* TBOC § 152.204; *see also* TRPA § 4.04.

945 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.
>
> (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.

946 *See In re Atlas Energy Resources LLC*, C.A. No. 4589-VCN, 2010 WL 4273122 (Del Ch. Oct. 28, 2010) (Because LLC agreement did not eliminate the fiduciary duties of the controlling unitholder owed directly to the LLC's minority unitholders, the Court evaluated the merger *sub judice* under the entire fairness standard of review, and denied defendants' motion to dismiss the claim for breach of fiduciary duty by the controlling unitholder.).

947 40 A.3d 839 (Del. Ch. 2012), *aff'd*, 59 A.3d 1206 (Del. 2012).

incorporated a core element of the traditional common law fiduciary duty of loyalty by providing 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.*,[948] 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:

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,[949] the Delaware Court of Chancery subsequently "considered the issue of default fiduciary duties and held that, subject to clarification from the Supreme Court, managers and managing members of an LLC <u>do</u> owe fiduciary duties as a default matter."[950] 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.[951]

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948 59 A.3d 1206 (Del. 2012), *aff'g* 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-llcsor-maybe-they-dont/.

949 *See infra* note 948 and related text.

950 *Zimmerman v. Adhezion Biomedical LLC*, 62 A.3d 676, 702 n.145 (Del. Ch. 2013) (*emphasis added*), referencing *Feeley v. NHAOCG, LLC*, No. 7304-VCL, 2012 WL 5949209, at *8-10 (Del. Ch. Nov. 28, 2012).

951 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 <u>the rules of law and equity relating to fiduciary duties and</u> 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 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

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).[952] The DLLCA does not have any provision which itself creates or negates Member or Manager fiduciary duties, but instead allows modification or elimination of fiduciary duties[953] by an LLC agreement, but does not allow the elimination of "the implied contractual covenant of good faith and fair dealing."[954]

Provisions in Company Agreements purporting to limit fiduciary duties need to be explicit and conspicuous as LLC coyness can lead to unenforceability.[955] A provision which 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.[956] A legal claim may exist for aiding and abetting a breach of fiduciary duty, whether arising under statute, contract, common law or otherwise.[957]

5.5. __Business Combinations__. Chapter 10 of the TBOC and Part Ten of LLC Act 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.[958] The merger must be pursuant to a written plan of merger containing certain provisions,[959] 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

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duties may be expanded, restricted or eliminated by the limited liability company agreement.

952 *See Fisk Ventures, LLC v. Segal*, C.A. No. 3017-CC, 2008 WL 1961156 (Del. Ch. 2008), *judgment aff'd* 984 A.2d 124 (Del. 2009).

953 DLLCA § 18-1101.

954 *Id. See* RESTATEMENT (SECOND) OF CONTRACTS § 205 and related Comment.

955 *See Solar Cells, Inc. v. True N. Partners, LLC,* C.A. No. 19477, 2002 WL 749163, at *4 (Del. Ch. Apr. 25, 2002).

956 *See Bay Center Apartments Owner, LLC v. Emery Bay PKI, LLC*, C.A. No. 3658-VCS, 2009 WL 1124451 (Del. Ch. April 20, 2009); *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).

957 *Fitzgerald v. Cantor*, C.A. No. 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).

958 However, the TBOC does impose restrictions on mergers involving nonprofit corporations. *See* TBOC § 10.010.

959 The TBOC's requirements are in its §§ 10.002 and 10.003. The LLC Act's requirements appear in its § 10.02.

appropriate certificate of merger with the Secretary of State, unless the plan of merger provides for delayed effectiveness.[960]

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.[961] The Tex. LLC Stats. grant broad authority for who can execute merger documents on a company's behalf.[962] 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.[963]

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.[964]

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.[965] In 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.[966]

5.6. <u>Indemnification</u>. 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.[967] The restrictions on indemnification applicable to for-profit corporations are not applicable to LLCs.[968] This approach is similar to the approach taken under Delaware law, but could be subject to public policy limitations.[969] 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

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960 TBOC § 10.007 and Revisor's Note thereto; LLC Act §§ 9.03, 10.03.

961 TBOC §§ 10.001, 101.356, 101.052; LLC Act § 10.01A. Under TBOC § 101.354 "majority" is determined on a per capita basis (i.e., one Member, one vote) unless the Company Agreement provides otherwise.

962 TBOC §§ 10.001(b), 10.151(b); LLC Act § 10.03A.

963 *See* TBOC § 10.006; LLC Act § 10.05.

964 TBOC §§ 10.101-10.105; LLC Act §§ 10.08-10.09. 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.

965 *See supra* notes 88-89 and related text regarding the requirements of TBOC §§ 21.451(2) (definition of "sale of all or substantially all of the assets") and 21.455 (procedure for approval thereof) and TBCA arts. 5.09 and 5.10.

966 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.

967 TBOC § 101.402; LLC Act § 2.20A.

968 *See generally* Chapter 8 of the TBOC, specifically § 8.002(a).

969 *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).

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. <u>Capital Contributions</u>. 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.[970] The Company Agreement ordinarily would contain provisions relative to when and under what circumstances capital contributions are required,[971] capital accounts and the allocation of profits and losses comparable to those in a limited partnership agreement.

5.8. <u>Allocation of Profits and Losses; Distributions</u>. 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.[972] 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.[973] 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.[974] 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.[975] 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.[976] The limitations on distributions by an LLC do not apply to

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970 TBOC § 1.002(9); LLC Act § 5.01. TBOC §§ 101.052 and 101.151 and LLC Act § 5.02 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 TBOC § 101.111(b) and LLC Act § 4.07 provide that an obligation to make a contribution will survive the assignment of the membership interest. TBOC § 101.156 and LLC Act § 5.02 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.

971 *See* Elizabeth S. Miller, *Practical Pitfalls in Drafting Texas Limited Liability Company Agreements*, 45:1 TEX. J. BUS. L. 27, 46 (2012).

972 TBOC §§ 101.052, 101.201; LLC Act §§ 5.02-1, 5.03. 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.

973 TBOC §§ 101.052, 101.201; LLC Act §§ 5.02-1, 5.03.

974 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.

975 TBOC § 101.206; LLC Act § 5.09A.

976 TBOC § 101.206(d); LLC Act § 5.09B; *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.

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.[977]

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.[978] Members may participate in the management of the LLC without forfeiting this liability shield,[979] but may be liable for their own torts.[980] Since

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977 TBOC § 101.206(f) as amended in 2009 Legislative Session by 2009 S.B. 1442 § 41.

978 TBOC §§ 101.114; 101.151; LLC Act §§ 4.03, 5.02A. 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.
>
> 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.

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.

979 The TBOC and the LLC Act do not contain any provision comparable to TBOC § 153.102 or TRLPA § 3.03, which make a limited partner liable for partnership obligations under certain circumstances if "the limited partner participates in the control of the business."

the Tex. LLC Stats. deal expressly with the liability of Members and Managers for LLC obligations, the principles of "piercing the corporate veil" should not apply to LLCs in Texas, although there are Texas Court of Appeals decisions to the contrary and the Supreme Court has not addressed the issue.[981]

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.[982] When applying corporate veil piercing standards to LLCs, these courts recognized that the provisions of TBCA Article 2.21 (Liability of Subscribers and Shareholders),

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980 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.

981 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 Pinebrook Props., Ltd. v. Brookhaven Lake Prop. Owners Ass'n*, 77 S.W.3d 487, 500 (Tex. App.—Texarkana 2002, pet. denied); *McCarthy v. Wani Venture*, A.S., 251 S.W.3d 573 (Tex. App.—Houston [1st Dist] 2007, no pet.); 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 *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 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.

982 *See*, *e.g.*, *Shook v. Walden*, 368 S.W.3d 604 (Tex. App.–Austin 2012, 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)).

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 amended[983] 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). 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.[984]

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.[985] 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 veil[986] or that the Members will have the same liabilities as corporate shareholders.[987]

5.10. <u>Nature and Classes of Membership Interests</u>. A membership interest in an LLC is personal property.[988] It does not confer upon the Member any interest in specific LLC property.[989] A membership interest may be evidenced by a certificate if the Company Agreement so provides.[990]

The Company Agreement may establish classes of Members having expressed relative rights, powers and duties, including voting rights,[991] 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.[992] The Company

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983 *See* S.B. 323 enacted in the 2011 Legislative Session.

984 *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).

985 *NetJets Aviation, Inc. v. LHC Commc'ns, LLC*, 537 F.3d 168, 176 (2d Cir. 2008); *In re Heritage Org., LLC*, No. 04-35574-BJH-11, 2008 WL 5215688 (Bankr. N.D. Tex. Dec. 12, 2008).

986 *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).

987 *See* W. VA. CODE § 31-B-3-303(b) (2003).

988 TBOC § 101.106; LLC Act § 4.04.

989 TBOC § 101.106; LLC Act § 4.04.

990 TBOC § 3.201(e); LLC Act § 4.05B.

991 Under TBOC § 101.354 Members vote on a per capita basis (i.e., one Member, one vote) unless the Company Agreement otherwise provides.

992 TBOC § 101.104; LLC Act § 4.02.

Agreement could provide for different classes of Members, each authorized to elect a specified number or percentage of the Managers.[993] 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.[994]

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.[995] The offer and sale of an interest must either be registered under applicable federal and state securities laws[996] or effected in a private[997] or other transaction structured to be exempt from those requirements.[998]

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993 *See* TBOC § 101.104; LLC Act § 2.13.

994 *See* 1993 LLC Bill Analysis at 2; *see also* TBOC §§ 21.152, 101.104.

995 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).

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 partnership, however, where the LLC is managed by its Members, the membership interest may not be deemed a security.

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).

996 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.

997 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." SEC Regulation D ("Reg D"), 17 C.F.R. 230.501-506 (2007), became effective April 15, 1982 and is now the controlling SEC

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.[999] 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.[1000]

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.[1001] 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 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.[1002] 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.[1003] 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.[1004] Until the assignee becomes a Member, the assignor continues

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regulation for determining whether an offering of securities is exempt from registration under § 4(2) of the 1933 Act.

998 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).

999 Post 9/1/95 B&CC §§ 8.102, 8.103(c).

1000 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.

1001 TBOC § 101.112; LLC Act § 4.06A, as amended in 2007 by 2007 H.B. 1737.

1002 TBOC § 101.108; LLC Act § 4.05A.

1003 *Id.*

1004 TBOC § 101.109; LLC Act § 4.05A.

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.[1005] 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.[1006] Until an assignee is admitted as a Member, the assignee does not have liability as a Member solely as a result of the assignment.[1007]

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.[1008]

5.12. <u>Winding Up and Termination</u>. The TBOC requires that an LLC commence winding up its affairs,[1009] and the LLC Act provided that an LLC is dissolved, upon the occurrence of any of the following events (a "<u>Winding Up Event</u>"):

(1) the expiration of the period (if any) fixed for its duration,[1010] which may be perpetual;[1011]

(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);[1012]

(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;[1013]

(4) the occurrence of any event that terminates the continued membership of the last remaining Member of the LLC, absent certain circumstances;[1014] or

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1005 TBOC § 101.111; LLC Act § 4.05A.

1006 TBOC §§ 101.109(b); 101.052; LLC Act § 4.07A. 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. TBOC §§ 101.110; 101.111(b); LLC Act § 4.07B.

1007 TBOC § 101.109(c); LLC Act § 4.05C.

1008 Tex. LLC Stats. provide that a membership interest is assignable unless otherwise provided by the Company Agreement. TBOC § 101.108(a); LLC Act § 4.05A. There is no statutory requirement of "reasonableness" with respect to LLC transfer restrictions as is found in TBOC §§ 21.211 and 21.213 and TBCA art. 2.22.

1009 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.

1010 TBOC § 11.051(1); LLC Act §§ 3.02A(2), 6.01A(1); *see* 1993 LLC Bill Analysis at 4.

1011 Under TBOC § 3.003 an LLC exists perpetually unless otherwise provided in its certificate of formation or Company Agreement.

1012 TBOC §§ 11.051(2), 101.552; LLC Act §§ 2.23D(2), 6.01A(3). *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.

1013 TBOC § 11.051(3); LLC Act § 6.01A(2).

(5) entry of decree of judicial dissolution under the Tex. LLC Stats.[1015]

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.[1016] In Delaware, however, the bankruptcy of a Member dissolves the LLC unless its LLC agreement otherwise provides.[1017]

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.[1018]

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.[1019] 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.[1020] 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.[1021] For other circumstances requiring termination under the TBOC, LLCs are permitted one year to cancel the event of termination.[1022]

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

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1014 TBOC § 11.056; LLC Act § 6.01A(5), as amended by 2003 H.B. 1637 effective September 1, 2003. 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. TBOC § 11.056; LLC Act § 6.01C, as amended by 2003 H.B. 1637 effective September 1, 2003.

1015 TBOC § 11.051(5); LLC Act §§ 6.01A(6), 6.02A.

1016 The bankruptcy of an entity is not a Winding Up Event under TBOC § 11.051.

1017 DLLCA § 18-304.

1018 TBOC §§ 101.552.

1019 TBOC § 11.152(b); LLC Act § 6.01B.

1020 TBOC § 11.151; LLC Act § 6.06A.

1021 TBOC § 11.152(a); LLC Act § 6.01B.

1022 TBOC § 11.152(a).

formation or Company Agreement or by resolution of the Managers or Members.[1023] Before filing a certificate of termination with the Secretary of State,[1024] 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,[1025] and (iii) collect its assets, discharge its obligations or make provision therefor and distribute the remaining assets to its Members.[1026] 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.[1027] 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.[1028]

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.[1029] 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.[1030] However, under the TBOC, such specific provision was unnecessary, as such entities may register directly to transact business in Texas under TBOC Chapter 9 and be afforded the limited liability shield.[1031] 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.[1032]

1023 TBOC § 101.551; LLC Act § 6.03A.

1024 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.

1025 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.

1026 TBOC § 11.052; LLC Act § 6.05.

1027 TBOC § 11.053(b); LLC Act § 6.05(A)(3). 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).

1028 TBOC §§ 11.055, 11.102; LLC Act § 6.08(B).

1029 TBOC chapter 101; LLC Act Part Seven.

1030 "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.

1031 *See* TBOC §§ 9.001 and 101.001 and the Revisor's Notes thereto.

1032 TBOC §§ 9.001, 9.004; LLC Act §§ 7.01A, 7.05.

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.[1033]

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.[1034] However, for matters affecting intrastate business in Texas, a Foreign LLC is subject to the same duties, restrictions, and liabilities as a domestic LLC.[1035] 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.[1036]

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.[1037] 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").[1038] Unlike the TPCA, however, physicians, surgeons and other doctors of medicine are not excluded from forming PLLCs under the Tex. LLC Stats.[1039]

A PLLC is required to contain in its name the words "Professional Limited Liability Company" or an abbreviation thereof.[1040] Only a "professional individual"[1041] or a "professional

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1033 TBOC § 9.251; LLC Act § 7.01B; TBCA art. 8.01B.

1034 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).

1035 TBOC § 9.203; LLC Act § 7.02A.

1036 TBOC § 9.051(c); LLC Act § 7.13B.

1037 *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).

1038 TEX. REV. CIV. STAT. ANN. art. 1528e, §3(a) (Vernon 2011).

1039 TBOC §§ 301.003, 301.012; 1993 LLC Bill Analysis at 6; LLC Act § 11.01.

1040 TBOC § 5.059; LLC Act § 11.02.

organization"[1042] may be a governing person[1043] of a PLLC.[1044] 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.[1045]

5.15. Series LLC. Subchapter M of TBOC Chapter 101[1046] was added in the 2009 Legislative Session[1047] to permit the formation of series LLCs ("Series LLC") which may establish series of Members, Managers, membership interests or assets to which different assets and liabilities may be allocated.[1048] The Texas Series LLC 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.[1049] 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 to winding-up and termination of the series.[1050]

1041 The LLC Act defines "professional individual" to mean an individual who is licensed to provide in Texas or another jurisdiction the same professional service as the PLLC. TBOC § 301.003(5); LLC Act § 11.01B(3).

1042 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.

1043 "Governing person" is a new defined term 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.

1044 TBOC §§ 301.007(a), 301.004(2); LLC Act § 11.03A.

1045 TBOC § 301.010; LLC Act § 11.05.

1046 TBOC §§ 101.601-101.521.

1047 Rick Tulli & Daryl Robertson, *2009 Legislative Update on Texas Business Organizations Code Amendments*, 43:3 TEX. J. BUS. L. 571 (2009).

1048 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).

1049 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.

1050 Rick Tulli & Daryl Robertson, *2009 Legislative Update on Texas Business Organizations Code Amendments*, 43:3 TEX. J. BUS. L. 571 (2009).

To form a Series LLC under the TBOC, the organizer must file a certificate of formation that expressly states that the entity is a Series LLC and contains a statement that the debts and liabilities of a series are of the series only and are enforceable only against the assets of that series and not those of any other series or of the Series LLC.[1051] The Series LLC's Company Agreement should also expressly state that the debts and liabilities of a series are of the series only and are enforceable only against the assets of that series and not any other series or the Series LLC.[1052] The records maintained for the Series LLC and each series must account separately for the assets of the Series LLC and each series.[1053] The certificate of formation for the Series LLC must state whether it is to be governed by its Members or by Managers.[1054] Its Company Agreement also should specify whether each series is to be governed by Managers or Members associated with the series.[1055]

A series of a Series LLC is not a separate entity under the TBOC.[1056] Although a series is not a separate entity for TBOC purposes, a series may grant security interests in its assets and file Uniform Commercial Code financing statements in the name of the series rather than that of the Series LLC.[1057]

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.[1058]

5.16. <u>Diversity Jurisdiction</u>. The citizenship of an LLC for federal diversity jurisdiction purposes is determined by looking to the citizenship of its Members, and, like a partnership, an LLC is deemed a citizen of each state in which it has a Member.[1059] In *Americold Realty Trust v. Conagra Foods, Inc.*,[1060] the U.S. Supreme Court, in a case involving a Maryland real estate investment trust, held: "While humans and corporations can assert their own citizenship, other entities take the citizenship of their members."

CHAPTER 6. LIMITED LIABILITY PARTNERSHIP.

6.1. <u>General</u>. 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 "<u>LLP Provisions</u>") added

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1051 TBOC § 101.602.

1052 *Id.*

1053 *Id.*

1054 TBOC § 101.608.

1055 TBOC §§ 101.607 and 101.608.

1056 TBOC § 101.622.

1057 TBC&C § 1.201(b)(27). TBC&C § 1.201(b)(27) was amended in the 2015 Legislative Session to provide that "Person" includes "a particular series of a for-profit entity" in order that a series could file a UCC-1 and thereby perfect a UCC security interest in assets of the series. See supra note 19

1058 *See infra* notes 1097-1101 and related text.

1059 *International Flavors & Textures, LLC v. Gardner*, 966 F.Supp. 552 (W.D. Mich. 1997).

1060 136 S. Ct. 1012 (2016).

to the TUPA by Sections 83-85 of House Bill 278 ("1991 H.B. 278").[1061] The LLP Provisions were refined and carried forward as section 3.08 of the TRPA[1062] passed in 1993, and then were substantially expanded by 1997 S.B. 555 effective September 1, 1997 ("1997 S.B. 555").[1063] 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 TBOC[1064] took effect on January 1, 2006 and governed all LLPs formed on or after that date.[1065] 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, after January 1, 2010, all LLPs (like all other Texas entities) became subject to the TBOC.[1066] 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")[1067] as an alternate means for allowing professionals the limitation of liability already available to them under the Texas Professional Corporation Act.[1068]

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.[1069] The "full shield" LLP statutes of a number of states (including Colorado,

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1061 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).

1062 TRPA § 1.01 et seq.

1063 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 continued 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).

1064 *See* TBOC Title 1 and §§ 152.801-152.805.

1065 TBOC §§ 401.001, 402.003, 402.005.

1066 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.

1067 Senate Bill 302 by Sen. John Montford ("1991 S.B. 302").

1068 TEX. REV. CIV. STAT. ANN. art. 1528e (Vernon Supp. 2010).

1069 *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).

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.[1070]

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.[1071]

A new subsection (5) was added to TRPA section 3.08(a) by 1997 S.B. 555[1072] 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.[1073] 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 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.[1074]

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.

1070 N.Y. Partnership Law § 26(c), (d) (McKinney 1988 & Supp.).

1071 TRPA § 3.08.

1072 The TBOC's parallel provision is in § 152.801(f).

1073 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.

1074 TBOC § 402.006.

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.[1075] 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 LLP must either (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 the LLP Provisions; or (2) provide $100,000 cash or cash equivalent deposit in an account[1076] 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 the LLP Provisions. The LLP insurance requirements were removed from the TBOC by 2011 SB 748.

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. A partner, however, is always liable for 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.

1075 TBOC § 402.006.

1076 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.

(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

(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.[1077]

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.[1078] 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.[1079] 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

1077 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.

1078 TBOC § 152.801(d)(1) after 2011 S.B. 748.

1079 TBOC § 152.801(d)(2) after 2011 S.B. 748.

assets from being reached to satisfy partnership obligations.[1080] 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.[1081] 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.[1082]

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.[1083] 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.

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.

6.4. 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.[1084]

6.4.2. Filing with the Secretary of State of Texas. LLPs are considered to be non-filing entities under the TBOC.[1085] Nonetheless, to achieve domestic LLP status, a partnership must file with the Secretary of State of Texas[1086] an application accompanied by a fee for each partner of

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1080 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."

1081 TEX. R. CIV. P. 28.

1082 TRPA § 3.08(a)(3)(C) (Vernon Supp. 2010).

1083 *See Elmer v. Santa Fe Properties, Inc.*, 2006 WL 3612359 (Tex. App.—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).

1084 TBOC § 5.063; TRPA § 3.08(c); 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.

1085 *See* TBOC §§ 1.002(57), (34).

1086 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 TBOC § 152.802 and TRPA § 3.08(b).

$200.[1087] 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,[1088] and (b) be executed by a majority in interest[1089] 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.[1090]

If the required information is supplied in the application and the fee is paid, the LLP registration becomes effective upon filing.[1091] There is no requirement for the Secretary of State 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.[1092]

Registration remains effective for a year,[1093] regardless of changes in the partnership, unless the registration is earlier withdrawn or revoked or unless renewed.[1094] 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 refiling with the Secretary of State until the next renewal filing.[1095] 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

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1087 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 TBOC § 4.158(1) and TRPA § 3.08(b)(3). For a foreign LLP, the fee is $200 per partner in Texas, not to exceed $750, under TBOC § 4.158(1) and TRPA § 10.02(c).

1088 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.

1089 "Majority in interest" is defined in TBOC § 151.001(3), TRPA § 1.01(10), and TRLPA § 1.02(7) 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.

1090 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).

1091 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* TBOC § 4.002; Tex. Admin. Code tit. 1, § 80.3 (2008).

1092 TBOC § 4.001(a)(2); TRPA § 3.08(b)(16).

1093 TBOC § 152.802(e); TRPA § 3.08(b)(5).

1094 TBOC § 152.802(e); TRPA §§ 3.08(b)(6), (7).

1095 *See* TBOC § 152.802(d); TRLPA § 3.08(b)(4); TEX. ADMIN. CODE tit. 1, §§ 80.1, 80.4 (2015).

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.[1096]

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").[1097] 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.[1098] 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.[1099] 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 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.[1100] 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.[1101] 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.[1102]

1096 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).

1097 Tex. Bus. & Com. Code § 71.001 *et seq.* (West 2015).

1098 TEX. BUS. & COM. CODE § 71.002(2)(G).

1099 TEX. BUS. & COM. CODE § 71.051.

1100 TEX. BUS. & COM. CODE § 71.054.

1101 TEX. BUS. & COM. CODE §§ 71.201, 71.202 and 71.203.

1102 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."

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.[1103] 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,[1104] 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.[1105] 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.*,[1106] 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 partnerships."[1107] However, there is nothing in the court's opinion suggesting that registration as an LLP is enough to make the partnership a different partnership.[1108]

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 "LLLP."[1109] 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,[1110] as permitted by its partnership agreement or with the consent of partners required to amend its partnership

1103 *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.).

1104 *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).

1105 *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).

1106 922 S.W.2d 626 (Tex. App.—Fort Worth 1996, writ denied).

1107 *Id.* at 629.

1108 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.

1109 *See* TBOC §§ 152.805, 1.002(47); TRPA § 3.08(e).

1110 TBOC § 152.802; TRPA § 3.08(b).

agreement to so permit, and (ii) contains in its name[1111] "limited liability partnership," "limited liability limited partnership" or an abbreviation thereof.[1112]

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.[1113] 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.[1114]

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.[1115] 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.[1116] 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.[1117] It would certainly be inconsistent 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,[1118] a

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1111 TBOC § 5.055(b).

1112 TBOC § 153.351; TRLPA § 2.14.

1113 TBOC § 153.102; TRLPA § 3.03.

1114 TBOC § 153.353; TRLPA § 2.14(c).

1115 TBOC § 152.801; TRPA § 3.08.

1116 *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.

1117 *See, e.g.*, *Flynn v. Reaves*, 218 S.E.2d 661 (Ga. App. 1975).

1118 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

creditor could argue that the partnership agreement supersedes the shield afforded by the Tex. LLP Stats.[1119] Since a partnership agreement may be written or oral,[1120] an LLP should have a written partnership agreement that provides that it may be amended only by a written amendment.

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.[1121]

6.5.9. Foreign LLP Qualification. A foreign LLP doing business in Texas[1122] may qualify to do business in Texas like a foreign LLC[1123] (the filing fee would be the lesser of $200 per resident partner[1124] or $750); however, the failure of the foreign LLP to qualify would not affect its LLP shield in Texas.[1125] Under the Tex. LLP Stats., the laws of the state under which a foreign LLP is formed will govern its organization and internal affairs and the liability of partners for obligations of the partnership.[1126]

> 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).

1119 Bishop, *The Limited Liability Partnership Amendments to the Uniform Partnership Act (1994)*, 53 BUS. LAW. 101, 118-120 (Nov. 1997).

1120 TBOC § 151.001(4); TRPA § 1.01(12).

1121 *Sterquell v. Archer*, No. 07-96-0218-CV, 1997 WL 20881, at *6 (Tex. App.—Amarillo 1997, writ denied).

1122 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 a non-exclusive list of activities not constituting transacting business in Texas. *See also* TBOC § 153.903; TRPA § 10.04.

1123 *See* TBOC Chapter 9 and §§ 152.901-152.914 and 402.001(e); TRPA article X.

1124 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
>
> (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.

1125 TBOC §§ 9.051, 152.910; TRPA § 10.03(c).

1126 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

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.[1127] 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."[1128]

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,[1129] 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.[1130]

6.5.10. Bankruptcy. Section 723 of the Bankruptcy Code[1131] 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.[1132]

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.[1133] As a result, large accounting firms with offices in most states are likely beyond the reach of the diversity jurisdiction of the Federal courts.[1134]

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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.

1127 TBOC §§ 1.101-1.105; TRPA § 10.01.

1128 TBOC § 1.002(43)(C)(i), providing substantively the same. *See also* Tex. Bus. & Com. Code § 271.004.

1129 DEL. CODE ANN., tit. 6, §§ 15-1001–15-1004.

1130 N.Y. P'SHIP LAW § 121-1502 (McKinney Supp. 2006); MD. CODE ANN. CORPS. & ASS'NS § 9A-1101 (1999).

1131 11 U.S.C. § 723, as amended by Pub.L. 103-394, Title II, § 212, Oct. 22, 1994, 108 Stat. 4125 (the "Bankruptcy Code").

1132 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.

1133 *Reisman v. KPMG Peat Marwick LLP*, 965 F. Supp. 165 (D. Mass. 1997), relying on *Carden v. Arkoma Assoc.*, 494 U.S. 185 (1990).

1134 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."

APPENDIX A

FEDERAL TAXATION OF ENTITIES

A. Federal "Check-The-Box" Tax Regulations.

1. Classification. Under the Internal Revenue Code of 1986, as amended (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

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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.*

or otherwise subject to special treatment under the IRC, e.g., real estate mortgage investment 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

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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).

the owners desire corporate classification rather than the default partnership classification. The 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 basis[13] 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 301.7701-2[17] (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,

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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).

it would have been classified as a corporation for purposes of federal income taxation and, if it 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

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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

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

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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.

[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).

whether to approve a proposed transfer.[28] These provisions are no longer appropriate except to 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

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.

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).

the date of the deemed distribution may result in gain recognition pursuant to I.R.C. §§ 704(c)(1)(B) and 737.[33]

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.

33 *See* I.R.C. §§ 704(c)(1)(B), 737.

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).

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 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

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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.

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 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. Prior to the passage of the Protecting Americans from Tax Hikes Act ("PATH Act") in 2015, an S-corporation that was previously a C-corporation was subject to a corporate level tax (i) if it realized 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 occurred within 10 years of that date[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 had subchapter C earnings and profits and more than 25% of its gross receipts for the year is passive investment income.[49] As part of the PATH Act, enacted December 18, 2015, Congress made permanent a 5-year recognition period which is effective for taxable years beginning after December 31, 2014.[50]

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.[51] To

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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) (prior to amendment by PATH Act) (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. § 1374(d)(7) as amended by PATH Act § 127(a) in 2015.

51 I.R.C. § 1366(d)(1); I.R.C. § 1367(b)(2)(A).

the extent a loss is not allowed due to this limitation, the loss generally is carried forward to the next year.[52]

(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 United States),[53] (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),[54] (iii) have no more than one class of stock[55] 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).[56] 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.[57] 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.[58]

(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.[59]

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52 I.R.C. § 1366(d)(2)(A).

53 I.R.C. § 1361(b)(1); I.R.C. § 1361(c).

54 I.R.C. § 1361(b)(1)(A)(c)(1) (as amended by The American Jobs Creation Act of 2004).

55 I.R.C. § 1361(b)(1)(D).

56 I.R.C. §§ 1361(b)(1)(B) and (C) and 1361(c)(6).

57 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).

58 I.R.C. § 1362(d)(1)-(3) (2005).

59 *See* BITTKER & EUSTICE, *supra* note 17, at § 6.04.

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 control[60] 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.[61]

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.[62]

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.[63]

2. Joint Venture/Tax Implications. A joint venture is commonly thought of as a limited duration general partnership formed for a specific business activity.[64] 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.[65]

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.[66] 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.[67] 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

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60 For these purposes, I.R.C. § 368(c) defines "control" as follows:

> [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.

61 I.R.C. § 351(a).

62 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).

63 Treas. Reg. § 301.7701-3(b)(1).

64 *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).

65 I.R.C. § 7701(a)(2) (2012).

66 I.R.C. § 721(a). *But see* Treas. Reg. § 1.707-3 (discussing disguised sales).

67 I.R.C. § 722; I.R.C. § 723.

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.

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.[68]

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.[69]

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.[70] 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.[71] Under certain circumstances, a partner's contribution of property may result in a net reduction in liability[72] 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.[73] 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.[74] 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.[75] 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:

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68 I.R.C. § 1402(a) (2004).

69 *See* Treas. Reg. § 301.7701-2(c)(1).

70 I.R.C. § 721(a). *But see* Treas. Reg. § 1.707-3 (discussing disguised sales).

71 I.R.C. § 722; I.R.C. § 723.

72 I.R.C. § 752.

73 I.R.C. § 731.

74 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).

75 *Lauren A. Howell v. Commissioner*, TC Memo 2012-303 (Nov. 1, 2012).

> Generally, an individual will be treated as a limited partner under the proposed regulations unless the individual (1) has personal liability (as defined in § 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.[76]

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.[77]

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.[78] 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.[79] 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.[80]

The IRS is nevertheless successfully challenging taxpayer claims of limited partner status where the taxpayer provided services to the partnership.[81]

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

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76 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).

77 *Id.*

78 Taxpayer Relief Act of 1997, Pub. L. 105-34, 111 Stat. 788 (1997) (enacted).

79 Taxpayer Relief Act of 1997, H.R. 2014, 105th Cong. § 734 (1997) (enacted).

80 S. 949, 105th Cong. § 734 (1997).

81 *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).

makes an election to be classified as an association taxable as a corporation.[82] A single Member 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.[83]

2. 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.[84] 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.[85] Under certain circumstances, a Member's contribution of property may result in a net reduction in liability[86] 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.[87] 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.[88] The tax rate on self-employment income consists of (i) a 12.40% social security equivalent tax on self-employment income up to a 2016 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).[89] An individual's wage income is applied against the contribution base.[90] Self-employment income generally means an individual's net earnings from the individual's trade or business.[91] 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

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82 Treas. Reg. § 301.7701-3(b)(i) (as amended in 2003).

83 Treas. Reg. § 301.7701-3(b)(ii).

84 I.R.C. § 721(a). *But see* Treas. Reg. § 1.707-3 (2003) (discussing disguised sales).

85 I.R.C. §§ 722, 723.

86 I.R.C. § 752.

87 I.R.C. § 731.

88 *See* I.R.C. § 1401; SSA Pub. No. 05-10003 (2014), *available at* http://www.ssa.gov/pubs/10003.html.

89 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.

90 I.R.C. § 1401(b)(2)(B).

91 I.R.C. § 1402(a).

share of income or loss from a limited partnership generally will not be included in his net income from self employment.[92]

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 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.[93] 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.[94] 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.[95] 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.[96]

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.

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92 I.R.C. § 1402(a). *See Lauren A. Howell v. Commissioner*, TC Memo 2012-303 (Nov. 1, 2012).

93 *See* 26 C.F.R. § 1.1402(a)-18, 59 Fed. Reg. 67,253-01 (proposed Dec. 29, 1994).

94 26 C.F.R. § 1.1402(a)-2, 62 Fed. Reg. 1702 (proposed Jan. 13, 1997).

95 *See id.*

96 *Id.*

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.[97] 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.[98] 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.[99] Congress may again consider ways to rationalize the self-employment tax treatment of LLCs, partnerships and S-corporations.[100]

The IRS is nevertheless successfully challenging taxpayer claims of limited partner status where the taxpayer provided services to the partnership.[101]

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.[102]

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.[103]

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97 H.R. CONF. REP. NO. 105-220, at 765 (1997).

98 *Id.*

99 *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.

100 *See "Options to Improve Tax Compliance and Reform Tax Expenditures"* prepared by the Staff of the Joint Committee on Taxation (January 27, 2005).

101 *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).

102 Treas. Reg. § 301.7701-3(b)(1).

103 *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

H. <u>3.8% Unearned Income Medicare Contribution Tax</u>.

In addition to the income taxes discussed above and for tax years beginning after December 31, 2012, individuals, estates and trusts are subject to an "Unearned Income Medicare Contribution Tax" on the lesser of their net investment income for the tax year or the excess of modified adjusted gross income ("<u>MAGI</u>") 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 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 as reduced by certain deductions disallowed for purposes of computing foreign earned income. 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.

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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

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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 school district 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.[8]

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 171[10] 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.

(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

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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.

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.

entirely composed of natural persons," and (iii) certain "passive" entities.[11] Thus, corporations, limited partnerships, certain general partnerships, LLPs, LLCs, business trusts and professional

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[11] 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.

associations are subject to the Margin Tax.[12] 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,[13] certain narrowly defined passive income entities[14] (including certain real estate

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(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.

12 Texas Tax Code Ann. § 171.0002(a).

13 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.

14 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")),[15] grantor trusts,[16] estates of a natural person, an escrow,[17] or a REMIC. Effective January 1, 2012, the Margin Tax does not apply to certain unincorporated political action committees.[18] Political action committees formed as Texas non-profit corporations are still subject to the Texas franchise tax.[19]

(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,[20] from

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(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.

15 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).

16 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." The Texas Supreme Court has confirmed that a trust is not an entity but a relationship. *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).

17 Tex. Tax Code Ann. § 171.0002(c).

18 Article 45 of Senate Bill 1 ("2011 S.B. 1") passed in 2011 Special Session.

19 *See Texas Tax Policy News* (Tex. Comptroller of Pub. Acts. Oct. 2011).

20 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,[21] (ii) securities[22] 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."[23] 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.[24]

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.[25] 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.[26] 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

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21 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).

22 Securities only include "non-controlling" interests. 34 T.A.C. § 3.582(b)(10).

23 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").

24 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.

25 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*).

26 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,[27] 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) with nexus in Texas 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.[28] Also, the Comptroller has determined that LLPs can qualify to be passive entities if they otherwise meet the 90% test for passive revenue.[29]

(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.[30]

(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.[31] The $1 million deduction passed in the 2013 Legislature change does not include a statutory expiration date. The versions of the Margin Tax[32] effective through 2016 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

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27 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").

28 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."

29 34 TEX. ADMIN. CODE § 3.582(c)(1)(C).

30 *See*, *e.g.*, TEX. TAX CODE ANN. § 171.088.

31 *See* Section 6 of HB 500 83rd Tex. Leg. Session.

32 *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 have the option to take a $1 million deduction. The 2015 Texas Legislature did not alter the $1,000,000 deduction.[33]

(f) Basic Calculation and Rates. Through 2016, the basic calculation of the Margin Tax is a taxable entity's (or unitary group's) gross receipts reportable for federal income tax purposes 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.[34] 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.[35] 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 2016 is .95% for all taxpayers except a narrowly defined group of retail and wholesale businesses which pay a .475% rate.[36]

For reports due on or after January 1, 2016, the tax rate drops to .75% for most taxpayers (.375 % for wholesale and retail).[37] There is a safety net so that the "tax base" for the Margin Tax may not exceed 70% of a business's total revenues.[38] 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.[39]

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.[40]

(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),[41] or IRS Form 1065 (for partnerships and other pass-through

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33 Tex. Tax Code § 171.002(d)(2).

34 *See, e.g.*, Texas Comptroller of Public Accounts Hearing 104,076 (Accession No. 201102012H, Feb. 23, 2011).

35 http://aixtcp.cpa.state.tx.us/opendocs/open32/201102012h.html.

36 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).

37 HB 32 84th Tex. Leg. Session (amending Tex. Tax Code § 171.002).

38 *See id.* § 171.101.

39 *Id.* § 171.1016.

40 *See infra* note 124 and related text.

41 *Id.* § 171.1011(c)(1).

entities),[42] plus dividends, interest, gross rents and royalties, and net capital gain income,[43] minus bad debts, certain foreign items, and income from related entities to the extent already included in the margin tax base.[44]

(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); [45] (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);[46] (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";[47] 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;[48] (C) the federal tax

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42 *Id.* § 171.1011(c)(2).

43 *Id.* § 171.1011(c)(1)(A).

44 *Id.* § 171.1011(c)(1)(B).

45 *Id.* § 171.1011(f).

46 *Id.* § 171.1011(g)(1).

47 *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.

48 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.

basis of securities and loans underwritten or sold;[49] (D) lending institutions may exclude loan principal repayment proceeds;[50] (E) dividends and interest received from federal obligations;[51] (F) reimbursements received by a "management company"[52] 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.[53]

Health care providers[54] 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."[55] Health care institutions[56] may exclude 50%[57] 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.[58] 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

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49 Tex. Tax Code §§ 171.1011(g)(2) and 171.1011(g-2).

50 *Id.* § 171.1011(g-1).

51 *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.

52 *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.

53 "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).

54 "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."

55 Tex. Tax Code § 171.1011(n).

56 *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.

57 *Id.* § 171.1011(o).

58 *Id.* § 171.1011(r).

closing price of gas is below $5 per MMBtu, as recorded on the New York Mercantile Exchange (NYMEX).[59]

Article 45 of 2011 S.B. 1 from the 2011 Special Session allows certain "live event promotion company[ies]" to exclude payments to artists.[60] Article 45 also allows qualified "courier and logistics company[ies]" to exclude certain subcontracting payments to non-employees performing delivery services.[61]

Sections 7 and 8 of H.B. 500 from the 2013 Texas Legislature allow exclusions from revenue for certain: (i) pharmacy network reimbursments; (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.[62]

(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.[63] It also includes "net distributive income" from partnerships, limited liability companies, and S Corporations to natural persons,[64] 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.[65] The deduction for wages and cash compensation for the return due May 15, 2016 may not exceed $360,000 plus benefits that are deductible for federal income tax purposes for any single person.[66] 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;[67] 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.

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59 *Id.* § 171.1011(s).

60 *Id.* § 171.1011(g-5) (effective January 1, 2012).

61 *Id.* § 171.1011(g-7) (effective January 1, 2012).

62 *See* Sections 7 and 8 of H.B. 500 83rd Tex. Leg. Session (effective for reports due on or after Jan. 1, 2014).

63 *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).

64 *Id.* § 171.1013(a)(1) & (2).

65 *Id.* § 171.1013(a)(3).

66 *Id.* § 171.1013(c).

67 *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.[68] 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.[69] 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.[70] 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.[71] The "cost of goods sold" must be capitalized to the extent required by I.R.C. § 263A.[72]

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.[73]

(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 15[74] of each year.

(l) Unitary Reporting. In another change from the pre-2008 franchise tax, which did not provide for consolidated tax reporting, the Margin Tax requires Texas businesses to file on a unitary and combined basis. An affiliated group of entities in a "unitary business"[75] must file a combined return including all taxable entities within the group.[76] The unitary group includes all

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68 *Id.* § 171.1012(c).

69 *Id.* § 171.1012(c) and (d).

70 *Id.* § 171.1012(e).

71 *Id.* § 171.1012(f).

72 *Id.* § 171.1011(g).

73 *See* Section 9 of H.B. 500 83rd Tex. Leg. Session (effective for reports due on or after Jan. 1, 2014).

74 *Id.* § 171.151(c).

75 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."

76 *Id.* § 171.1014.

affiliates[77] with a common owner (i.e., greater than 50% owned),[78] and the group includes entities with no nexus in Texas.[79]

(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."[80] The application of this standard proved unworkable, and the Comptroller's Rule 3.590[81] 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.[82]

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.
>
> (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.[83]

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

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77 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*]

78 *Id.* § 171.0001(8).

79 *See id.* § 171.1014(c).

80 *Id.* § 171.0001(1).

81 34 TEX. ADMIN. CODE § 3.590 (Public Finance, Margin: Combined Reporting) (Effective January 1, 2008).

82 *Id.* § 3.590 (b)(4)(E).

83 *Id.* § 3.590.

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."[84] 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."[85] 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."[86]

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.[87] 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.[88] Passive entities or exempt entities may not be included in a combined group.[89]

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.[90] In order to avoid double taxation the combined

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84 34 T.A.C. § 3.590(b)(4)(A)(i).

85 34 T.A.C. § 3.590(b)(4)(A)(ii).

86 34 T.A.C. § 3.590(b)(4)(A)(iii).

87 *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.

88 Tex. Tax Code § 171.1014(a).

89 34 T.A.C. § 3.590(b)(2)(B) & (F).

90 *Id.* § 171.1014(d).

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.[91]

(n) Apportionment. The Margin Tax is apportioned using a single-factor gross receipt formula (Texas gross receipts divided by aggregate gross receipts).[92] Receipts that are excluded from the tax base must also be excluded from gross receipts for apportionment purposes.[93]

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.[94] 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).[95] 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).[96]

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.[97] 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.[98]

(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.[99] 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.[100] 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 report due from a taxable entity after January 1, 2008, on a form prescribed by the Comptroller.[101] A taxable entity may only claim the credit if the entity was subject to franchise tax on May 1, 2006.[102] The right to claim the NOL credit may not be transferred to another

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91 *Id.* § 171.1014(c)(3).

92 *Id.* § 171.106(a).

93 *Id.* § 171.1055(a).

94 *Id.* § 171.103(a).

95 *Id.* § 171.103(b).

96 *See* deletion from former TEX. TAX CODE ANN. § 171.103(a)(1) (amended 2006).

97 *Id.* § 171.105(c).

98 *Id.* § 171.105(b).

99 34 TEX. ADMIN. CODE § 3.594 (2007) (Public Finance, Franchise Tax, Margin: Temporary Credit).

100 *Id.*

101 *Id.*

102 *Id.*

entity and changes to the membership of a combined group can prejudice the right to utilize the NOL credit.[103]

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.[104] 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%.[105] For report years 2018–2027, the credit for the business loss carryforward amount x 7.75% x 4.5%.[106]

(p) R&D Credit From 2013 Texas Legislature. H.B. 800 from the 2013 Texas Legislature allows a taxpayer[107] to elect to take: (i) sales tax exemption for "tangible personal property directly used in qualified research;"[108] 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 Code[109] and is further conditioned by the requirement that the qualified research must be conducted within Texas.[110] 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%[111] X ((qualified research expenditures in the tax report year) - (50% of the average qualified research expenditures during the three tax periods preceding the tax report))

The R&D tax credit may not exceed 50% of the amount of the franchise tax due in any given report year[112] before the application of any other credits, but unused credits may be carried forward for up to 20 years.[113]

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103 *Id.*

104 *Id.*

105 *Id.*

106 *Id.*

107 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.

108 *See* Section 2 of H.B. 800 83rd Tex. Leg. Session; Tex. Tax Code Section 151.3182(b) (effective Jan. 1, 2014).

109 *See* Section 2 of H.B. 800 83rd Tex. Leg. Session (effective Jan. 1, 2014); Tex. Tax Code Section 151.3182(a)(3).

110 *See* Section 3 of H.B. 800 83rd Tex. Leg. Session (effective Jan. 1, 2014); Tex. Tax Code Section 171.651(3).

111 A higher credit amount of 6.25% is allowed for contracts with institutions of higher education.

112 Tex. Tax Code Section 171.658 (added by H.B. 800 2013 Tex. Legislature).

113 Tex. Tax Code Section 171.659 (added by H.B. 800 2013 Tex. Legislature).

(q) 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 Texas[114] 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) 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.[115] The rehabilitation credit takes effect January 1, 2015. The amount of the credit may not exceed 25% of the total eligible coss and expenses inccurred in the qualifying rehabilitation project.[116] 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.[117]

(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.[118]

(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.[119]

4. Constitutionality of Margin Tax Upheld in *Allcat*. On November 28, 2011, the Texas Supreme Court reported its *Allcat* decision[120] that the Texas franchise, tax does not does not violate the Texas Constitution's so-called "Bullock Amendment" which prohibits "a tax on the net incomes of natural persons."[121] Allcat Claims Service, L.P., and one of its individual

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114 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).

115 See Section 14 H.B. 500 2013 Texas Legislature adding Section 171.901 through 171.909 to the Texas Tax Code (effective Jan. 1, 2016).

116 Tex. Tax Code Section 171.905 (effective Jan. 1, 2016).

117 Tex. Tax Code Section 171.906 (effective Jan. 1, 2016).

118 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.

119 *See* Appendix A Federal Taxation of Entities ("Appendix A") at F.3 Taxation of LLCs – Self-Employment Tax.

120 *In re Allcat Claims Service, L.P.*, No. 11-0589, 2011 WL 6091134 (Tex. Nov. 28, 2011).

121 The Bullock Amendment to Texas Constitution article 8, section 24(a),[121] 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

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).[122]

> 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]

122 *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 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,

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.

5. <u>Classification of Margin Tax Under GAAP</u>. The Margin Tax is classified as an income tax in financial statements prepared in accordance with GAAP.[123] The minutes of

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> 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.

123 *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"):

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.[124] 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 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

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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."

124 TEX. TAX CODE ANN. § 171.1032(c) (Vernon 2002 & Supp. 2004); Tex. S.B. 1125, 77th Leg., R.S. (2001).

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.[125] 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,[126] 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.[127] However, in Revenue Procedure 99-51 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

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125 *See* Appendix A Federal Taxation of Entities at B. Business Combinations Generally.

126 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).

127 *See*, *e.g.*, I.R.S. Priv. Ltr. Rul. 99-42-009 (October 25,1999).

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 partnership[5]
- LLP[6]
- Limited partnership[7]
- LLC[8]
- S-corporation[9]

(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]

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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 *See* Chapter 5 – Limited Liability Company.
4 *See* Appendix A at C.1 Check the Box Regulations.
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 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:

- State income taxation issues in other states; and

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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.

- 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 2016. In each case, the entity is assumed to have (i) \$1,000 of gross revenue,[20] (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 FICA base amount for the tax year (\$118,500 for 2016) 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).

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 in addition to regular federal

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18 *See* Chapter 7 – Extraterritorial Recognition of LLC and LLP Limited Liability.

19 *See* Appendix A at C.2 Taxation of S-Corporations.

20 The chart ignores the availability of the \$1 million deduction under Section 171.101(a)(1)(A)(ii) of the Texas Tax Code.

income tax liability, it is taken into account for purposes of calculating estimated tax penalties of 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 as reduced by certain deductions disallowed for purposes of computing foreign earned income. 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 Rate = .0075 [c]	5.25	5.25	5.25	5.25
Taxable Income of Entity	94.75	94.75	94.75	94.75
Fed. Income Tax (at 35%)	33.16	0	0	0
Income After Taxes[d]	66.84	94.75	94.75	94.75
Owner Level				
Distribution & Share of Income	66.84	94.75	94.75	94.75
Self-Employment Tax	0	2.75[e]	2.75[e]	0
Taxable Income of Owner	66.84	93.38[f]	93.38[f]	94.75
Fed. Tax on Dividends (20%) or Income Allocation (39.6%)	13.37	36.98	36.98	37.52
Amount Received After Personal Income Taxes	**53.47**	**56.40**	**56.40**	**57.23**

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(a) Individuals are subject to a self-employment tax on self-employment income. For 2016 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 2016 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. 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 2016, (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 0.75% (the rate is 0.375% for a narrowly defined group of retail and wholesale businesses) for tax reports due after January 1, 2016. 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 2016 report. Tex. Tax Code § 171.002. The chart also assumes the taxpayer does not elect to use the "E-Z Computation" allowable to taxable entities with gross revenues of not more than $10 million as provided in Section 171.1016 of the Texas Tax Code.

(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) Neither the IRS or the courts have issued definitive guidance on the application of the self-employment tax for members of an LLC. See discussion of self-employment tax in Appendix A Section F(3).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.

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C. <u>ENTITY COMPARISON CHART</u>.

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

Texas Law Entity	*Check-the-Box*	*Federal Taxation*	*TX Franchise Tax*[21]
Proprietorship	**Not Applicable**	**Form 1040, Schedule C or E**	**None**
LLC / single individual member	**Disregarded**[22]	**Form 1040, Schedule C or E (Proprietorship)**	**Yes**
LLC / single entity member	**Disregarded**[2]	**Division of Member Entity**	**Yes**
General Partnership or LLP	**Partnership**[23]	**Partnership**	**Depends**
General Partnership or LLP	**Corporation**	**C or S-Corp**[24]	**Depends**
Limited Partnership	**Partnership**[3]	**Partnership**	**Yes**
Limited Partnership	**Corporation**	**C or S-Corp**[4]	**Yes**[25]
LLC / multi-members	**Partnership**[3]	**Partnership**	**Yes**
LLC / multi-members	**Corporation**	**C or S-Corp**[4]	**Yes**
Corporation	**Not Applicable**	**C or S-Corp**[4]	**Yes**

21 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.

22 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.

23 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).

24 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).

25 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.