Jackson Walker

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Choice of Entity and Key Contents of Organization Documents

Jackson Walker L.L.P. Corporate CLE Series: Lifecycle of a Company

Byron F. Egan – Bio Information

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

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

Publications: Mr. Egan writes and speaks about the areas in which his law practice is focused, and is a frequent author and lecturer regarding M&A, governance of corporations, partnerships and limited liability companies, securities laws, and financing techniques. He is the author of the treatise EGAN ON ENTITIES: Corporations, Partnerships and Limited Liability Companies in Texas (2016) (available on Amazon). 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: B.A. and J.D., University of Texas
After law school, Byron served as a law clerk for Judge Irving L. Goldberg on the United States Court of Appeals for the Fifth Circuit.

Honors: For more than 25 years, Byron has been listed in The Best Lawyers in America under Corporate, M&A or Securities Law. He is the 2015 recipient of the Texas Bar Foundation's Dan Rugeley Price Memorial Award, which is presented annually to a lawyer who has an unreserved commitment to clients and to the legal profession. He won the Burton Award for distinguished legal writing four times. Byron has been recognized as one of the top corporate and M&A lawyers in Texas by a number of publications, including *Corporate Counsel Magazine, Texas Lawyer, Texas Monthly, The M&A Journal* (which profiled him in 2005) and *Who's Who Legal*. In 2009, his paper entitled "Director Duties: Process and Proof" was awarded the Franklin Jones Outstanding CLE Article Award and an earlier version of that article was honored by the State Bar Corporate Counsel Section's Award for the Most Requested Article in the Last Five Years.

Publications

Treatise by Byron F. Egan entitled EGAN ON ENTITIES: Corporations, Partnerships and Limited Liability Companies in Texas (2016) ("EGAN ON ENTITIES"), which is available on Amazon.

- *Choice of Entity Decision Tree*, TexasBarCLE & Business Law Section of State Bar of Texas Choice, Governance & Acquisition of Entities Course, San Antonio, May 20, 2016 ("***Choice of Entity paper***"): www.jw.com/choice-entity-decision-tree-2016/
- *Acquisition Structure Decision Tree*, TexasBarCLE & Business Law Section of State Bar of Texas Choice, Governance & Acquisition of Entities Course, San Antonio, May 20, 2016 ("***Acquisition Structure paper***"): www.jw.com/acquisition-structure-decision-tree/
- *Joint Venture Governance and Business Opportunity Issues*, University of Texas School of Law 11th Annual Mergers and Acquisitions Institute, Dallas, October 15, 2015 ("***Joint Venture paper***"): www.jw.com/joint-venture-governance-and-business-opportunity-issues/

Five Business Entity Forms

- Corporation
- General Partnership
- Limited Partnership
- Limited Liability Partnership ("LLP")
- Limited Liability Company ("LLC")

Texas Secretary of State – Statistical Information

Certificates of Formation Filed for Calendar Year 2015	
Domestic For-Profit Corporation	22,756
Domestic Limited Liability Company	135,250
Domestic Limited Partnership	5,676
Domestic Nonprofit	10,856
Domestic Professional Corporation	747
Domestic Professional Association	597
Domestic Limited Liability Partnership Statistics for Calendar Year 2015	
Registrations of Domestic Limited Liability Partnership	741
Renewals of Domestic LLP Registrations	2,817

Texas Secretary of State – Statistical Information

MASTER FILE STATISTICS AS OF JANUARY 1, 2016	
Entity Type	Active Entities
Domestic For-Profit Corporation	369,746
Domestic Limited Liability Company	742,663
Domestic Limited Partnership	132,661
Domestic Nonprofit	132,826
Domestic Professional Corporation	17,820
Domestic Professional Association	18,751

Delaware Secretary of State – Statistical Information

Certificates of Formation Filed for Calendar Year 2015	
Domestic For-Profit Corporation	38,288
Domestic Limited Liability Company	128,042
Domestic Limited Partnership	10,288
Master File Statistics for December 31, 2015	
Entity Type	Active Entities
Domestic For-Profit Corporation	290,799
Domestic Limited Liability Company	780,245
Domestic Limited Partnership	87,150

Texas Business Organizations Code

- Enacted by the Texas Legislature in 2003.
- Referred to as "***<u>TBOC</u>***" or "***<u>Code</u>***".

See EGAN ON ENTITIES pp 2-15

Texas Business Organizations Code

- Became effective for new entities formed under Texas law after January 1, 2006. **[TBOC §§ 1.002(20); 402.001]**
- After January 1, 2010, TBOC governs all Texas entities.**[TBOC § 402.005]**

See EGAN ON ENTITIES pp 2-15

Texas Business Organizations Code

- TBOC codified source law.
- TBOC has been amended every Legislative Session in response to cases and other states' statutory changes.

See EGAN ON ENTITIES pp 2-15

Federal Income Taxes
[EGAN ON ENTITIES Appendix A]

- "**Check-the-Box**" Regulations [EGAN ON ENTITIES Appendix A pp 1-4]
- Corporations
  - Rates 15%-35%
  - Shareholders taxed on dividends at 20% plus 3.8% Unearned Income Medicare Contribution Tax ("net investment income tax") on the lesser of (1) the taxpayer's net investment income for the tax year or (2) the excess of modified adjusted gross income 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)
- Partnerships and LLC
  - "Flow thru" entities with no entity level tax
  - Tax at owner level

Margin Tax
[EGAN ON ENTITIES Appendix B]

- Enacted in 2006
- Margin Tax Returns due May 15 for calendar year tax payers.
- Applies to all business entities.
  - Exceptions: (i) general partnerships which are not LLPs and all of whose partners are individuals and (ii) entities 90% of whose gross income is from narrowly defined passive income sources.
  - Does not apply to sole proprietorships.
- Margin Tax base is taxable entity's (or unitary group's) gross receipts after deductions for either:
  - Compensation, or
  - Cost of goods sold,
- Provided that the Margin Tax base may not exceed 70% of a business's total revenues.
- Looks like income tax, but in 2012 Texas Supreme Court in *Allcat* held not income tax.

Margin Tax – cont'd
[EGAN ON ENTITIES Appendix B]

- Apportion to Texas: multiply the tax base by a fraction:

  $$\frac{\text{Texas gross receipts}}{\text{aggregate gross receipts}}$$

- Tax rate for 2017 applied to the Texas portion of the tax base is 0.75%.
  - Exception for retail and wholesale businesses which pay a 0.375% rate.
- Margin Tax changes the calculus for entity selections, but not necessarily the result.
  - LLC has become more attractive as it can elect to be taxed as a corporation or partnership for federal income tax purposes. [EGAN ON ENTITIES Appendix A pp 1-3; Appendix C]
  - Uncertainties as to an LLC's treatment for self employment purposes can restrict its desirability in some situations. [EGAN ON ENTITIES Appendix A pp 14-16]

Decision Matrix
[EGAN ON ENTITIES Appendix C]

- Key elements in deciding among business entities are:
    - How the entity will be taxed.
    - Who will be liable for its contract, tort and statutory obligations (entity itself will always be liable to the extent of its assets; question is whether owners will be liable if entity's assets insufficient to satisfy all claims).Margin Tax changes the calculus for entity selections, but not necessarily the result.
- If the owners are content to pay federal income taxes at the entity level (15% to 35%) and then pay taxes on earnings distributed to them, the choice may be regular business corporation without an S-corporation election.
    - Comparable tax result may be achieved with LLC that elects to be taxed as C-corporation under IRS Check-the-Box Regulations.
    - LLC may be preferable because greater governance structuring flexibility.

Decision Matrix – cont'd
[EGAN ON ENTITIES Appendix C]

- If the owners do not want the entity's earnings to be taxed twice, the choices are:
    - General partnership
    - LLP
    - Limited partnership
    - LLC
    - S-corporation.
- If limited liability of the owners is not decisive, the choice may be a <u>general partnership</u> as it is not subject to the Margin Tax, although partners are jointly and severally liable for all partnership liabilities.

Decision Matrix – cont'd
[EGAN ON ENTITIES Appendix C]

- 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 pay the Margin Tax, the <u>LLP</u> may be the entity of choice:
  - Law firms typically organized as LLPs because not subject to old franchise tax when choice of entity decision made.
  - Margin Tax may change choice to PLLC as comparable liability shield, both LLP and PLLC can be partnerships for federal tax purposes but subject to Margin Tax, and PLLC not subject to $200 per partner per year fee payable to the Secretary of State.

Decision Matrix – cont'd
[EGAN ON ENTITIES Appendix C]

- The limited partnership provides 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, but has its own limitations:
  - Must have a general partner which is liable for all partnership obligations — contract and tort — but under Check-the-Box Regulations, capitalization of general partner is not important (which allows use of nominally capitalized LLC as general partner) and a limited partnership can elect to also be an LLLP which has the effect of limiting the liability of the general partner.
  - Limited partners who participate in management of the business may become liable as general partners, but statutes generally allow a degree of participation and no liability unless creditor relied upon the limited partner as a general partner.
  - Desirable for (i) family entities when some members want to retain control while spreading asset values among children or extended family and (ii) O&G and real estate syndications when flow through tax treatment important and promoters want to retain control with limited fiduciary duties.

Decision Matrix – cont'd
[EGAN ON ENTITIES Appendix C]

- The LLC can be structured to have tax flow through and limited liability of S-corporation or limited partnership without any of the drawbacks for them, but:
  - Subject to the Margin Tax.
  - Self-employment tax issues (see EGAN ON ENTITIES Appendix A pp 14-16).
  - Maximum governance flexibility as company agreement can define how entity will be managed and limit fiduciary duties and liabilities of managers.

Decision Matrix – cont’d
[EGAN ON ENTITIES Appendix C]

- 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 Margin Tax. Under the Internal Revenue Code, S-corporation status is not available where the entity:
  - has more than <u>100</u> equity holders;
  - has more than <u>one</u> class of stock;
  - has among its shareholders any:
    - general or limited partnership
    - trust (certain exceptions)
    - non resident alien
    - corporation (exception for “qualified subchapter S subsidiary”).

TAX COSTS IN CHOICE OF ENTITY DECISION
[EGAN ON ENTITIES Appendix C p 5]

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 2017. In each case, the entity is assumed to have (i) $1,000 of gross revenue, (ii) $700 of gross margin for Margin Tax purposes, which would be the maximum taxable margin under Tex. Tax Code § 171.101(a)(1) and all of which is apportioned to Texas under Tex. Tax Code § 171.101(a)(2), and (iii) $100 of net income that is of a type subject to self-employment taxes (i.e., is income from a trade or business and is not investment income) and is distributed (after taxes) to its owners. It is also assumed that the individual owners will have earned income or wages in excess of the base amount for the tax year and will therefore be subject to only a 2.9% (3.8% on individual self employment income in excess of $200,000 [$250,000 in the case of a joint return; $125,000 in the case of a married taxpayer filing separately]) Medicare tax on all self employment income (there is no ceiling), and not the 12.40% social security equivalent tax to a base of $127,200 in 2017.

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
Tex. Margin Tax Rate = .0075 [c]	5.25	5.25	5.25	5.25
Fed. Taxable Income of Entity	94.75	94.75	94.75	94.75
Fed. Income Tax (at 35%)	33.16	0.00	0.00	0.00
Cash After Taxes[d]	61.59	94.75	94.75	94.75
Owner Level				
Distribution & Share of Income	61.59	94.75	94.75	94.75
Self-Employment Tax	0.00	2.75[e]	2.75[e]	0.00
Taxable Income of Owner	61.59	93.38[f]	93.38[f]	94.75
Fed. Tax on Dividends (20%) or Income Allocation (39.6%)	12.32	36.98	36.98	37.52
Amount Received After Personal Income Taxes	**49.27**	**56.40**	**56.40**	**57.23**

(a) Individuals are subject to a self-employment tax on self-employment income. For 2017 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 2017 contribution base of $127,200 (adjusted annually for inflation), plus (ii) a 2.9% (3.8% on individual self-employment income in excess of $200,000 [$250,000 in the case of a joint return; $125,000 in the case of a married taxpayer filing separately]) tax for hospital insurance ("***Medicare***") on all self-employment income (there is no ceiling). This self-employment tax is treated as part of the income tax and must also be taken into account for purposes of the estimated tax. A similar addition to Medicare tax applies for FICA purposes. If the taxpayer has wages subject to FICA, then the taxpayer's social security equivalent wage base would be reduced by amount of wages on which these taxes were paid. There is no cap on self-employment income subject to the Medicare tax.

(b) Assumes that the entity is treated as a partnership for federal income tax purposes. A general partnership which has not qualified as an LLP would not be subject to the Margin Tax.

(c) Assumes that (i) Margin Tax is applicable since gross receipts are all in 2017, (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 for 2017 is 0.75% (the rate is 0.375% for a narrowly defined group of retail and wholesale businesses). 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 C to EGAN ON ENTITIES. Assumes the business cannot take advantage of the $1 million alternative minimum deduction effective for the 2017 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, also 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 EGAN ON ENTITIES on pages 14-15 of Appendix A under Section F(3) Self-Employment Tax. 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 on pages 4-5 of Appendix C of EGAN ON ENTITIES under B.2 – 3.8% Unearned Income Medicare Contribution Tax.

State of Incorporation

- Delaware
  - Chancery Court
    - court of equity
    - no jury
    - nuanced precedent
- Business judgment rule
  - Not applicable to duty of loyalty claims
  - Courts say they do not second guess informed business judgment of directors, but do scrutinize whether Board asked for and got enough information to make an informed business judgment

State of Incorporation – cont'd

- Partnership and LLC Agreements Respected
  - Unlike TBOC, Delaware statutes governing partnerships and LLCs provide that their policy is to give maximum effect to the principle of freedom of contract and to entity agreements and allow the elimination of fiduciary duties (but not the contractual duty of good faith and fair dealing) [EGAN ON ENTITIES paper pp 166; 183].
  - Judicial application of these principles illustrated by six recent cases discussed in EGAN ON ENTITIES pp 166-167 involving limited partnership reorganizations in which the general partner or an affiliate was the survivor or acquiring party. In four of them, the Delaware Supreme Court affirmed the elimination of common law fiduciary duties and their replacement with a provision authorizing related party transactions if a conflicts committee of independent directors in good faith determines that the transactions are in the best interests of the partnership. The fifth decision applied the implied covenant of good faith and fair dealing (which cannot be eliminated) and held that a fairness opinion was inadequate to support a transaction with the GP because it only covered the fairness of the entire transaction rather than to the LPs.
  - In the sixth decision Vice Chancellor Laster in *El Paso Pipeline Partners, L.P. Derivative Litigation* on April 20, 2015 awarded $171 million to the plaintiff limited partners because it found that the conflicts committee of the Board of the general partner did not in fact believe in good faith that the transaction was in the best interests of the partnership because its analysis focused on whether the purchase would enable the partnership to increase its distributions rather than whether it was paying too much for the assets. In a 60 page opinion the Court found that the testimony of the committee members that they had a good faith belief that the transaction was in the best interests of the partnership was not credible because their emails and other objective evidence showed that they were simply going through the motions to approve a transaction they knew general partner wanted and never considered saying no. The Court also focused on the conclusionary nature of the information provided and second guessed the analysis of the committee's financial advisor.

State of Incorporation – cont'd

- Respect for Stockholder Voting Rights
  - Lenders frequently insist that their credit agreements give them the right to accelerate the loans if there is a change in control of the borrower.
  - In *Amylin* case an indenture provision permitted acceleration of the notes if directors approved by prior Board ceased to comprise a majority of the directors was challenged in the course of a proxy contest and the Court in essence held that the existing Board could and should approve the insurgent's slate in order to avoid a default even through it was opposing them in the proxy contest. Plaintiff argued Board violated its duty of care by not focusing on the change in control provision when approving the indenture and, in approving a settlement in which plaintiff's counsel was awarded a $2.9 million fee, the Court criticized borrower's counsel for not focusing the Board on the change in control provision.
  - In *Pontiac General Employees Retirement System v. Ballantine* (known as the *Healthways* case) a loan agreement was entered into in the context of a contested election which contained an acceleration right triggered by a new Board majority within a 24-month look back period (called a "dead hand proxy put"). Plaintiff sued for a declaratory judgment that the proxy put was unenforceable because the Board breached its fiduciary duties by approving the provision and the bank for aiding and abetting their violation. The Vice Chancellor Laster denied defendants motion to dismiss and as settlement in the case was approved on May 8, 2015 in which the provision was amended out of the credit agreement and the plaintiff's lawyer received a $1.2 million fee.

State of Incorporation

- Nevada
  - Little precedent
  - Statutes modeled after Delaware
- New York
  - Personal liability of 10 largest shareholders for wages of non-public corporation. *Whitely v. Moravec*, 635 F.3d 308 (7th Cir. 2011)

Governance Parameters

- Partnerships and LLCs are creatures of contract.
- They have greater governance structuring flexibility than corporations.
- Their governing persons generally owe fiduciary duties to the entity and its owners.

EGAN ON ENTITIES pp 362-373; 376-398; 403-438

Governance Parameters

- Corporations are typically governed by directors who owe fiduciary duties to the entity and its owners.

See EGAN ON ENTITIES pp 68-148

Governance Parameters

The standard fiduciary duties for corporations, partnerships, LLPs and LLCs include:

- Care
- Loyalty
  - Candor
  - Self-dealing
  - Business Opportunities
- Obedience

Source of Fiduciary Law

Both the TBOC and the Delaware General Corporation Law (the "*DGCL*") provide that the business and affairs of a corporation are to be managed under the direction of its board of directors ("*Board*").

Source of Fiduciary Law

The TBOC 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.

Source of Fiduciary Law

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.

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," [*Edgar v. MITE Corp.*, 457 U.S. 624, 645 (1982)] **and "under the commerce clause a state has no interest in regulating the internal affairs of foreign corporations."** [*McDermott, Inc. v. Lewis*, 531 A.2d 206, 217 (Del. 1987)]

Applicable Law – Internal Affairs Doctrine

- Internal corporate affairs are "those matters which are peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders."
- A corporation's internal affairs are to be distinguished from matters which are not unique to the relationships among a corporation and its governing persons.

Applicable Law — Internal Affairs Doctrine

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, including the liability of an owner or governing person of the entity for actions taken in that capacity.

Applicable Law – Internal Affairs Doctrine

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

TBOC §1.105 provides:

- 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.

Applicable Law – Internal Affairs Doctrine

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. *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).

Applicable Law – Internal Affairs Doctrine

- Delaware also subscribes to the internal affairs doctrine.

See EGAN ON ENTITIES pp 71-72

Applicable Law — Contractual Freedom of Choice

Texas Business & Commerce Code §271.001 *et seq*. allows contractual freedom of choice of law in “qualified transactions” involving at least $1 Million, but generally does not trump the internal affairs doctrine for fiduciary duties cases.

Fiduciary Duties in Texas Cases

- As the Fifth Circuit noted in *Gearhart Industries, Inc. v. Smith International*, Texas has its own body of precedent with respect to director, officer and controlling shareholder fiduciary duties, distinct from the law developed in Delaware and other jurisdictions.

See EGAN ON ENTITIES p 74

Fiduciary Duties in Texas Cases

In *Gearhart*, 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 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."

See EGAN ON ENTITIES p 74

Formal and Informal Fiduciary Duties

In Texas there are two types of fiduciary relationships out of which fiduciary duties arise.

- (1) a <u>formal</u> fiduciary relationship, which arises as a matter of law (directors and officers owe formal fiduciary duties).
- (2) 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.

See EGAN ON ENTITIES pp 75-76

Formal and Informal Fiduciary Duties

- Whether undisputed facts give rise to a <u>formal</u> fiduciary relationship is a question of law.
- Whether an <u>informal</u> fiduciary relationship exists is ordinarily a question of fact because the underlying material facts are disputed.
- When the underlying facts are undisputed, however, the determination of whether a fiduciary relationship exists is a question of law for the court.

See EGAN ON ENTITIES pp 75-76

Formal and Informal Fiduciary Duties

- Fiduciary duties (both formal and informal) are owed to the corporation and all of its shareholders, but generally not to individual shareholders.
- An officer or director of a closely-held company "may become" a fiduciary to individual shareholders when the corporation repurchases the shareholder's stock.

See EGAN ON ENTITIES pp 75-76

Formal and Informal Fiduciary Duties

- Controlling shareholders generally do not owe formal fiduciary duties to minority shareholders, but may owe informal fiduciary duties to the minority shareholders.

See EGAN ON ENTITIES pp 75-76

Ritchie v. Rupe

On June 20, 2014, the Texas Supreme Court issued its opinion in *Ritchie v. Rupe*, 443 S.W.3d 856 (Tex. 2014) holding that:

- For claims of “minority shareholder oppression” the sole remedy available under Texas law is a statutory receivership.
- Common law fiduciary duties, as articulated in *Gearhart* are still the appropriate lens through which to evaluate the conduct of directors of Texas corporations.

See EGAN ON ENTITIES pp 75-82

Ritchie v. Rupe

"Minority shareholder oppression" can be defined essentially as acts of a majority shareholder group that are harmful to a minority shareholder without necessarily harming the corporation itself.

Ritchie v. Rupe

Gearhart held 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. ”

Ritchie v. Rupe

The Fifth Circuit commented in *Gearhart* 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
- (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.

Ritchie v. Rupe

The *Gearhart* decision stated a strong business judgment rule:

- "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."

Ritchie v. Rupe: Informal Fiduciary Duty

- The Supreme Court remanded *Ritchie v. Rupe* to the Court of Appeals to consider the plaintiff's fiduciary duty claim against the 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."
- 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."
- 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; the Supreme Court denied the petition for review.

Sneed v. Webre

On May 29, 2015, the Texas Supreme Court in *Sneed v. Webre*, 465 S.W.3d 169, 178 (Tex. 2015), 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, held:

> "The business judgment rule in Texas generally protects corporate officers and directors, who owe fiduciary duties to the corporation, from liability for acts that are within the honest exercise of their business judgment and discretion."

Sneed v. Webre

Following *Ritchie v. Rupe* and *Gearhart*, the Texas Supreme Court in *Sneed v. Webre* cited and quoted from the 1889 Supreme Court opinion of *Cates v. Sparkman* as setting the standard for judicial intervention in cases involving duty of care issues noting:

- 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.

Gross Negligence Claims after Sneed, Ritchie and Gearhart

- 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.
- Earlier Federal District Court decisions in the context of lawsuits by the Federal Deposit Insurance Corporation and the Resolution Trust Company arising out of failed financial institutions 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."
- 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. *See Floyd v. Hefner*, C.A. No. H-03-5693, 2006 WL 2844245, at *28 (S.D. Tex. Sept. 29, 2006).

Other Minority Shareholder Remedies: The Statutory Scheme

Many Texas fiduciary duty cases arise in the context of closely held corporations. In holding that "minority shareholder oppression" is not a separate cause of action, the Supreme Court in *Ritchie v. Rupe* noted that the Legislature has enacted "a comprehensive statutory scheme with a careful balance of policies and interests" which are coupled with contractual and common law protections.

Other Minority Shareholder Remedies: Books and Records Access

A common complaint of those alleging shareholder oppression is the denial of access to the corporation's books and records

- The Legislature has expressly protected a corporate shareholder's right to examine corporate records, provided penalties for a violation of those rights, and identified applicable defenses in an action to enforce those rights.
- TBOC §§ 21.218 (examination of records), 21.219 (annual and interim statements of corporation), 21.220 (penalty for failure to prepare voting list), 21.222 (penalty for refusal to permit examination), 21.354 (inspection of voting list) and 21.372 (shareholder meeting list).

Other Minority Shareholder Remedies: Withholding or Refusing to Declare Dividends

- Texas statutes generally do not dictate when directors must declare dividends or how much the dividends must be and leave those decisions within the discretion of a corporation's directors, who must make those decisions in compliance with the formal fiduciary duties that they owe.
- When directors breach their fiduciary duties by improperly withholding or failing to declare dividends, one or more shareholders can sue the directors for breach of those duties on behalf of the corporation through a derivative action under TBOC §§ 21.551–.563.
- *See, e.g.*, *Patton v. Nicholas*, 279 S.W.2d 848, 849–53 (Tex. 1955), in which the Court wrote "when corporate controllers misappropriate corporate funds for their own use or pay themselves excessive salaries out of corporate coffers, they do so in violation of their fiduciary duty to the corporation, and the law affords a remedy for that misconduct."

Other Minority Shareholder Remedies: Termination of Employment

- A minority shareholder's loss of employment with a closely held corporation can be particularly harmful because a job and its salary are often the sole means by which shareholders receive a return on their investment in the corporation, but Texas is steadfastly an at-will employment state.
- If the termination is for no legitimate business purpose, intended to benefit the directors or individual shareholders at the expense of the minority shareholder and harmful to the corporation, such action could violate the directors' fiduciary duties to exercise their "uncorrupted business judgment for the sole benefit of the corporation" and to refrain from "usurp[ing] corporate opportunities for personal gain."

See EGAN ON ENTITIES pp 77-80; 87-92; 103-109

Other Minority Shareholder Remedies: Conflicts of Interest

- The 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 EGAN ON ENTITIES pp 77-80; 87-92; 103-109

Other Minority Shareholder Remedies: Manipulation of Stock Values

- In circumstances in which the controlling shareholders or directors of a closely held corporation seek to artificially deflate the shares’ value (perhaps to allow the company or its shareholders to purchase a minority shareholder’s shares for less than their true market value, or to hinder a minority shareholder’s sale of shares to third parties), the directors’ fiduciary duties to the corporation provide protection for minority shareholders affected by such conduct when the conduct harms them in their capacity as shareholders.

Other Minority Shareholder Remedies: Derivative Claims

- Fiduciary duty causes of action are derivative in nature as they involve injury to the entity, and thus belong to the entity.
- TBOC § 21.563, however, provides in the case of a corporation with fewer than 35 shareholders, a court, if justice requires, may treat a derivative claim as a direct claim and allow recovery directly by the aggrieved shareholder.

See EGAN ON ENTITIES 173 – 175

- Further, TBOC § 11.404 contemplates that if it is established that "the action of the governing persons of the entity are illegal, oppressive or fraudulent," a rehabilitative receiver may be appointed by the court.

Personal Liability for Breach of Fiduciary Duty

- **Directors and officers have personal liability for breach of fiduciary duties.**
- **Statutes provide some ways to limit director fiduciary duty liability:**
  - Certificate of formation provisions limiting director (but not officer) liability for breach of the fiduciary duty of care (but not breaches of duty of loyalty or actions not in good faith)

See EGAN ON ENTITIES pp 189-191

  - Renounce individual business opportunities in a charter provision or by Board resolution

See EGAN ON ENTITIES p 191

  - Interested director transactions if (i) approved by disinterested Board or committee after disclosure; (ii) approved by the shareholders after disclosure; or (iii) fair to the corporation.

See EGAN ON ENTITIES p 191

Duty of Loyalty

- As a result of strong business judgment rule in Texas and the ability to limit by charter liability for breaches of the duty of care, most plaintiffs frame their complaints in terms of breaches of duty of loyalty.
- The duty of loyalty requires a director to act in good faith and not allow his or her personal interest to prevail over those of the corporation.

See EGAN ON ENTITIES pp 76-77

- Duty of loyalty breaches include:
  - Self-dealing transactions See EGAN ON ENTITIES pp 77-78
  - Misappropriation of business opportunities See EGAN ON ENTITIES pp 78-80
  - Candor See EGAN ON ENTITIES p 80
  - Severe failure of oversight [EGAN ON ENTITIES p 80]. (Often called "*Caremark* claims" after 1998 Delaware Chancery case that articulated the duty)

See EGAN ON ENTITIES pp 92-104

- Officers are agents and have fiduciary duties/liabilities comparable to directors; but the charter cannot limit officers' liability.

See EGAN ON ENTITIES pp 145-148

Fiduciary Duties
Delaware Law

Chancery Court

- court of equity
- no jury
- nuanced precedent

Standards of Review – EGAN ON ENTITIES pp 234-258

- Delaware Standards of Review. Under Delaware law, there are generally three standards against which the courts will measure director conduct in the context of considering a business combination transaction:
  - *business judgment rule* – for a decision to remain independent or to approve a transaction not involving a sale of control;
  - *enhanced scrutiny* – for a decision to adopt or employ defensive measures or to approve a transaction involving a sale of control; and
  - *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.

Fiduciary Duties
Delaware Law

Business Judgment Rule - EGAN ON ENTITIES pp 132-136, 259-304

- 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." *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). "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.'" *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)).
- The directors' 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.'" *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985). In *Van Gorkom*, notwithstanding a transaction price substantially above the current market, directors were held to have been grossly negligent in, among other things, acting in haste without adequately informing themselves as to the value of the corporation.
- The business judgment rule is not applicable to duty of loyalty claims. *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009).

Fiduciary Duties
Delaware Law

- 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.
  - Defensive Measures. In *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)), 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." 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) 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).

Fiduciary Duties
Delaware Law

– Sale of Control. In *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 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. 506 A.2d 173, 184 n.16 (Del. 1986).
  - In *Lyondell Chemical Company v. Ryan*, 970 A.2d 235, 237 (Del. 2009), the Delaware Supreme Court 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.
  - The *Lyondell* opinion should also be read as a statement that (i) 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, (ii) *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, and (iii) when the *Revlon* duties become applicable, there is no single blueprint that a Board must follow to satisfy its *Revlon* duties.
  - In *C&J Energy Services, Inc. v. City of Miami General Employees' and Sanitation Employees' Retirement Trust*, 107 A.3d 1049 (Del. 2014), the Delaware Supreme Court held that the *Revlon* duty requires a Board 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.

Fiduciary Duties
Delaware Law

- <u>Entire Fairness</u>. 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 "<u>controller</u>") stands on both sides of the transaction. In reviewing Board action in transactions involving management, Board members or a principal shareholder, the Delaware Supreme Court has imposed an "***entire fairness***" standard.
  - While a stockholder owning a majority of a corporation's stock will typically be found to be a controller, a stockholder owning less than 50% of the voting stock may be a controller if its stock ownership combined with other factors allows it to dominate the governance of the corporation. *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).
  - In *Kahn v. M&F Worldwide Corp.*, the Delaware Supreme Court held that the business judgment rule review can apply to squeeze-out mergers conditioned up front on <u>both</u> approval by a special committee and a majority-of-the-minority vote.
  - 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*, CA No. 8703-VCL (August 27, 2015), 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.

Fiduciary Duties
Delaware Law

- Action Without Bright Lines. Whether the burden will be on the party challenging Board action, under the business judgment rule, or on the Board, 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.

Alternative Entities

LLCs and partnerships are "*alternative entities*"

- Courts apply "contractarian" approach in measuring fiduciary duties of partners.

- Texas LLC and partnership statutes allow modification (but not elimination) of common law duties.

- Delaware allows partnership and LLC agreements to eliminate fiduciary duties, but cannot be "coy" in wording.

- TBOC only allows restriction and 2013 amendment to TBOC allows limitation of governing person liability to the extent permitted for corporations (eliminate duty of care but not loyalty).

Alternative Entities – Texas

- Fiduciary duties of general partners [See EGAN ON ENTITIES pp 370-372; 382-398; 413-438] are highest and include:
  - Care
  - Loyalty
  - Candor
- Fiduciary duties of managers of LLC analogous to corporate directors absent contractual definition [See EGAN ON ENTITIES pp 413-438].

Delaware Law — Partnership and LLC Agreements Respected

- Unlike TBOC, Delaware statutes governing partnerships and LLCs provide that their policy is to give maximum effect to the principle of freedom of contract and to entity agreements
- Delaware statutes allow the elimination of fiduciary duties
- Delaware statues do not allow elimination of contractual duty of good faith and fair dealing

See EGAN ON ENTITIES pp 388-398; 419-438

Delaware Law — Partnership and LLC Agreements Respected

- Six recent Delaware cases involving limited partnership reorganizations
- General partner or an affiliate was the survivor or acquiring party in each

See EGAN ON ENTITIES pp 392-398

Delaware Law — Partnership and LLC Agreements Respected

- In four cases, the Delaware Supreme Court affirmed the elimination of common law fiduciary duties and their replacement with a provision authorizing related party transactions if a conflicts committee of independent directors in good faith determines that the transactions are in the best interests of the partnership.

See EGAN ON ENTITIES pp 392-398

Delaware Law — Partnership and LLC Agreements Respected

- The fifth decision applied the implied covenant of good faith and fair dealing (which cannot be eliminated) and held that a fairness opinion was inadequate to support a transaction with the GP because it only covered the fairness of the entire transaction rather than fairness to the LPs.

See EGAN ON ENTITIES pp 392-398

Delaware Law — Partnership and LLC Agreements Respected

•In the sixth decision Vice Chancellor Laster in *El Paso Pipeline Partners, L.P. Derivative Litigation* on April 20, 2015 awarded $171 million to the plaintiff limited partners.

•The Court found that the conflicts committee of the Board of the general partner did not in fact believe in good faith that the transaction was in the best interests of the partnership because its analysis focused on whether the purchase would enable the partnership to increase its distributions rather than whether it was paying too much for the assets.

•In a 60 page opinion the Court found that the testimony of the committee members that they had a good faith belief that the transaction was in the best interests of the partnership was not credible because their emails and other objective evidence showed that they were simply going through the motions to approve a transaction they knew general partner wanted and never considered saying no.

•The Court also focused on the conclusionary nature of the information provided and second guessed the analysis of the committee's financial advisor.

Owner Liability for Entity Obligations

General partnership

- Partners are jointly and severally liable for partnership obligations, but after 2011 creditors must exhaust partnership assets before pursuing partners.

See EGAN ON ENTITIES pp 368-371

Owner Liability for Entity Obligations

LLP

- Partners are not liable for contractual obligations of the partnership or torts of other partners.

  See EGAN ON ENTITIES pp 463-476

- 2011 Legislation clarified that liability is incurred when the contract is entered into or the tort event occurred; it eliminated liability for action of other partners supervised or involved in the same activity; and it deleted the requirement of $100,000 of insurance.

Owner Liability for Entity Obligations

LP

- General partner liable for all partnership obligations (unless LLLP) (could have LLC with nominal assets)
- Limited partners not liable for partnership obligations unless participate in management of business and creditor relied upon limited partner as a general partner

See EGAN ON ENTITIES pp 379-381

Owner Liability for Entity Obligations

Corporations

- Shareholders generally not liable for entity obligations
- TBCA art. 2.21/TBOC § 21.223:
  - No liability for contracts unless alter ego or fraud.
  - No piercing for contract or tort for failure to comply with TBOC, corporate governing documents or corporate formalities

See EGAN ON ENTITIES pp 60-65

Owner Liability for Entity Obligations — “Piercing the Corporate Veil”

- *Castleberry v. Branscum* (Tex. 1986).
- *SSP Partners* (Tex. 2008): rejects single enterprise veil piercing theory and applies TBCA art. 2.21 to tort cases]

See EGAN ON ENTITIES pp 62-64

Owner Liability for Entity Obligations – "Piercing the Corporate Veil"

LLC

See EGAN ON ENTITIES pp 442-448

- Legislative History of Texas LLC Statute:
  - 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.

See EGAN ON ENTITIES p 443 at note 1496

- Some cases suggest corporate veil piercing concepts apply to LLCs. TBOC §101.002 amended in 2011 to provide TBOC veil piercing limitations for corporations also apply to LLCs if veil piercing permitted.

See EGAN ON ENTITIES pp 442-448

Business Entity Acquisition Decision Tree [*Acquisition Structure* paper]

Alternative Structures for Acquisitions of Businesses [*Acquisition Structure* paper pp 3-7]

- There are three basic forms of business acquisitions:
  - Statutory business combinations (e.g., mergers, consolidations and share exchanges);
  - Purchases of shares; and
  - Purchases of assets.

Alternative Structures for Acquisitions of Businesses – cont'd

- Statutory business combinations
  - Can merge one or more corporations, LLCs or partnerships pursuant to a single plan of merger.
  - Mergers and consolidations require a plan of merger approved by directors and shareholders of each entity, followed by filing certificate of merger with Secretary of State; results in the merging of one entity into another entity which ends up with assets and liabilities of both constituent entities
  - Can be structured to be taxable or non-taxable for federal income tax purposes
  - Reverse triangular merger (buyer forms subsidiary which merges into target with target surviving and results in buyer owning all of stock of target; in forward triangular merger, target merges into merger subsidiary which is the survivor; reverse triangular merger taxed as sale of stock but forward triangular merger taxed as sale of assets).

Alternative Structures for Acquisitions of Businesses – cont'd

- **Divisive merger – under TBOC § § 1.002(55)(A) and 10.001-10.008, an entity can merge itself creating two or more surviving entities (plan of merger can divide assets and liabilities among parties, but limited prejudice to rights of existing creditors)**
- TBOC § 10.008(a) provides when a merger takes effect upon the filing of a certificate of merger with the Secretary of State, the separate existence of the constituent entities ceases, and all assets and liabilities of the constituent entities are vested in the surviving entity without "any transfer or assignment having occurred." This means that all assets of constituent entities move in accordance with the plan of merger, <u>but</u> under TBOC a merger is <u>not</u> an "***<u>assignment</u>***" for purposes of provisions in contracts prohibiting assignment <u>unless</u> (1) the contract is an IP license (see *Cincom Systems, Inc. v. Novelis Corp.*, 581 F.3d 431 (6^{th} Cir. 1009) discussed in note 15 on p 10 of *Acquisition Structure* paper) or (2) the contract provides that a merger is deemed to be an assignment or otherwise prohibits the merger. See note 13 on page 9 of *Acquisition Structure* paper for Delaware *Mezo Scale* holding that reverse triangular merger is not an assignment under certain contract provisions.

Alternative Structures for Acquisitions of Businesses – cont'd

- Purchases of Shares
  - Can structure on a taxable or non-taxable basis
  - In a voluntary stock purchase, the acquiring corporation must generally negotiate with each selling shareholder individually
  - Statutory "share exchange" permitted by TBOC (but not DGCL) under which the vote of holders of the requisite percentage (but less than all) of shares can bind all of the shareholders to exchange their shares pursuant to the plan of exchange approved by such vote. Statutory share exchange particularly useful where regulatory requirements make stock purchase desirable, but entity has too many shareholders to expect 100% of shareholders will agree to stock purchase agreement or can be located.
  - Target's liabilities unaffected

Alternative Structures for Acquisitions of Businesses – cont'd

- Asset Purchases
  - Asset purchases feature the advantage of specifying the assets to be acquired and the liabilities to be assumed.
  - "C" corporation generally recognizes gain on a sale of assets even in connection with a complete liquidation; shareholders of the target are taxed as if they had sold their stock for the liquidation proceeds (less the target's corporate tax liability).
  - As a general rule and subject to tax considerations, in the buyer's best interests to purchase assets, but in the seller's best interests to sell stock or merge.

Alternative Structures for Acquisitions of Businesses – cont'd

- Asset transactions are typically more complicated and more time consuming than stock purchases and statutory combinations because transfer of the seller's assets to the buyer must be documented and separate filings or recordings may be necessary to effect the transfer (e.g., real property deeds, lease assignments, patent and trademark assignments, motor vehicle registrations, etc.).
- In contrast to a stock purchase, the buyer in an asset transaction will only acquire the assets described in the acquisition agreement (assets to be purchased are often described with specificity in the agreement and the transfer documents; often excluded are cash, accounts receivable, litigation claims or claims for tax refunds, personal assets and certain records pertaining only to the seller's organization; puts the burden on the seller to specifically identify the assets that are to be retained).
- Among the assets to be transferred will be the seller's rights under contracts pertaining to its business (often contractual rights cannot be assigned without the consent of other parties – e.g., leases of real property and equipment, IP licenses, and joint ventures or strategic alliances; many government contracts cannot be assigned and require a novation with the buyer after the transaction is consummated).

Alternative Structures for Acquisitions of Businesses – cont'd

- Unlike a stock purchase or statutory combination, where the acquired corporation retains all of its liabilities and obligations, known and unknown, the buyer in an asset purchase has an opportunity to determine which liabilities of the seller it will contractually assume.
  - One of the most important issues to be resolved is what liabilities incurred by the seller prior to the closing are to be assumed by the buyer.
  - It is rare in an asset purchase for the buyer not to assume some of the seller's liabilities relating to the business (e.g., the seller's obligations under contracts for the performance of services or the manufacture and delivery of goods after the closing).
  - For unknown liabilities or liabilities that are imposed on the buyer as a matter of law, the solution is not so easy and lawyers spend significant time and effort dealing with the allocation of responsibility and risk in respect of such liabilities (many acquisition agreements provide that none of the liabilities of the seller, other than those specifically identified, are being assumed by the buyer and then give examples of the types of liabilities not being assumed (e.g. tax, products and environmental liabilities)).

Alternative Structures for Acquisitions of Businesses – cont'd

- There are some recognized exceptions to a buyer's ability to avoid the seller's liabilities by the terms of the acquisition agreement, including the following:
  - Bulk sales laws permit creditors of a seller to follow the assets of certain types of sellers into the hands of a buyer unless specified procedures are followed.
  - Under fraudulent conveyance or transfer statutes, the assets acquired by the buyer can be reached by creditors of the seller under certain circumstances. Actual fraud is not required and a statute may apply merely where the purchase price is not deemed fair consideration for the transfer of assets and the seller is, or is rendered, insolvent.
  - Liabilities can be assumed by implication, which may be the result of imprecise drafting or third-party beneficiary arguments that can leave a buyer with responsibility for liabilities of the seller.
  - Some state tax statutes provide that taxing authorities can follow the assets to recover taxes owed by the seller; often the buyer can secure a waiver from the state or other accommodation to eliminate this risk.
  - Under some environmental statutes and court decisions, the buyer may become subject to remediation obligations with respect to activities of a prior owner of real property.
  - In some states, courts have held buyers of manufacturing businesses responsible for tort liabilities for defects in products manufactured by a seller while it controlled the business. Similarly, some courts hold that certain environmental liabilities pass to the buyer that acquires substantially all the seller's assets, carries on the business and benefits from the continuation.
  - The purchaser of a business may have successor liability for the seller's unfair labor practices, employment discrimination, pension obligations or other liabilities to employees.
  - In certain jurisdictions (not Texas), 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 "***de facto merger***." This theory would result in the buyer assuming all of the seller's liabilities.

Alternative Structures for Acquisitions of Businesses – cont'd

- Many state and local jurisdictions impose sales, documentary or similar transfer taxes on the sale of certain categories of assets.
- A sale of assets may yield more employment or labor issues than a stock sale or statutory combination, because the seller will typically terminate its employees who may then be employed by the buyer (perhaps on different terms) or have to seek other employment.

Alternative Structures for Acquisitions of Businesses – cont'd

- Common Threads in any Acquisition Agreement: Although the actual form of the agreement for the sale of a business can involve many variations, there are many common threads involved for the draftsman. The principal segments of a typical agreement for the sale of a business include:
  - Introductory material (i.e., opening paragraph and recitals);
  - The price and mechanics of the business combination;
  - Representations and warranties of the buyer and seller;
  - Covenants of the buyer and seller;
  - Conditions to closing;
  - Indemnification;
  - Termination procedures and remedies; and
  - Miscellaneous (boilerplate) clauses.

Non-Reliance Provisions in Contracts

Entire Agreement/Contractual Limitation of Extra contractual Liabilities [*Acquisition Structure* paper pp 303-323]

- **Section 13.7 Entire Agreement, Non-reliance, Exclusive Remedies and Modification**

(a) This Agreement supersedes all prior agreements, whether written or oral, between the parties with respect to its subject matter (including any letter of intent and any confidentiality agreement between Buyer and Seller) and constitutes (along with the Disclosure Letter, Exhibits and other documents delivered pursuant to this Agreement) a complete and exclusive statement of the terms of the agreement between the parties with respect to its subject matter. This Agreement may not be amended, supplemented or otherwise modified except by a written agreement executed by the party to be charged with the amendment.

(b) Except for the representations and warranties contained in Article 3 [the representations and warranties section of the Agreement], (i) none of Seller or any Shareholder has made any representation or warranty, expressed or implied, as to Seller or as to the accuracy or completeness of any information regarding Seller furnished or made available to Buyer and its representatives, (ii) Buyer has not relied upon, and will not assert that it has relied upon, any information regarding Seller, or the transactions contemplated by this Agreement, not set forth in Article 3, and (iii) none of Seller or any Shareholder shall have or be subject to any liability to Buyer or any other Person resulting from the furnishing to Buyer, or Buyer's use of or reliance on, any such information or any information, documents or material made available to Buyer in any form in expectation of, or in connection with, the transactions contemplated by this Agreement.

(c) Following the Closing, the sole and exclusive remedy for any and all claims arising under, out of, or related to this Agreement, or the sale and purchase of the Seller, shall be the rights of indemnification set forth in Article 11 [the indemnification section of the Agreement] only, and no person will have any other entitlement, remedy or recourse, whether in contract, tort or otherwise, it being agreed that all of such other remedies, entitlements and recourse are expressly waived and released by the parties hereto to the fullest extent permitted by law.]

(d) The provisions of this Section 13.7 and the limited remedies provided in Article 11, were specifically bargained for between Buyer and Sellers and were taken into account by Buyer and the Sellers in arriving at the Purchase Price. The Sellers have specifically relied upon the provisions of this Section 13.7 and the limited remedies provided in Article 11 in agreeing to the Purchase Price and in agreeing to provide the specific representations and warranties set forth herein.

(e) All claims or causes of action (whether in contract or in tort, in law or in equity) that may be based upon, arise out of or relate to this Agreement, or the negotiation, execution or performance of this Agreement (including any representation or warranty, whether written or oral, made in or in connection with this Agreement or as an inducement to enter into this Agreement), may be made only against the entities that are expressly identified as parties hereto. No Person who is not a named party to this Agreement, including without limitation any director, officer, employee, incorporator, member, partner, stockholder, Affiliate, agent, attorney or representative of any named party to this Agreement ("***Non-Party Affiliates***"), shall have any liability (whether in contract or in tort, in law or in equity, or based upon any theory that seeks to impose liability of an entity party against its owners or Affiliates) for any obligations or liabilities arising under, in connection with or related to this Agreement or for any claim based on, in respect of, or by reason of this Agreement or its negotiation or execution; and each party hereto waives and releases all such liabilities, claims and obligations against any such Non-Party Affiliates. Non-Party Affiliates are expressly intended as third party beneficiaries of this provision of this Agreement..

(f) This Agreement may not be amended, supplemented or otherwise modified except by a written agreement executed by the party to be charged with the amendment.

Non-Reliance Provisions in Contracts –Case Law

ABRY Partners V, L.P. v. F&W Acquisition LLC, 891 A.3d 1032 (Del. Ch. 2006) (stock purchase agreement non-reliance clause that the buyer was not relying upon any representations and warranties not stated in the contract generally enforceable when the product of give-and-take between commercial parties who had the ability to walk away freely).

Non-Reliance Provisions in Contracts –Case Law

RAA Management, LLC v. Savage Sports Holdings, Inc., 45 A.3d 107 (Del. 2012) (non-reliance disclaimer language in a confidentiality agreement was effective to bar fraud claims by a prospective buyer).

Non-Reliance Provisions in Contracts –Case Law

Italian Cowboy Partners, Ltd. v. Prudential Ins. Co. of America, 341 S.W.3d 323 (Tex. 2011) (pure merger clauses, without an expressed clear and unequivocal intent to disclaim reliance or waive claims for fraudulent inducement, do not defeat claim for fraudulent inducement).

Non-Reliance Provisions in Contracts –Case Law

Allen v. Devon Energy Holdings, L.L.C. F/K/A Chief Holdings, L.L.C., 367 S.W.3d 355 (Tex. App. – – Houston [1st Dist.] 2012)(case settled in 2013) (in the context of allegations by seller that CEO and majority owner fraudulently induced seller to sell and citing *Abry* and *Italian Cowboy*, held that disclaimer and release provisions relating to the value of the company did not negate reliance or materiality as a matter of law, as omissions related to seller's decision whether to sell rather than value of company; fact issue existed as to fraud and the existence of a fiduciary relationship).

Non-Reliance Provisions in Contracts –Case Law

Staton Holdings, Inc. v. Tatum, LLC, 345 S.W.3d 729 (Tex. App.--Dallas 2011) (express negligence doctrine applies to non-reliance clauses).

Confidentiality Agreements

- A confidentiality agreement is the first stage for the due diligence process in negotiated transactions as parties generally are reluctant to provide confidential information to the other side without having the protection of a confidentiality agreement.
- The target typically proposes its form of confidentiality agreement, and a negotiation of confidentiality agreement ensues.

Confidentiality Agreements

- Covenants in confidentiality agreements are enforceable and misuse of confidential information can lead to sanctions.
- *See Martin Marietta Materials, Inc. v. Vulcan Materials Co.*, 68 A.3d 1208 (Del. 2012) (hostile tender offer enjoined because bidder misused information received under confidentiality agreement entered into during aborted negotiations for friendly deal).

Confidentiality Agreements

- In an asset purchase, confidential information is part of the assets purchased and the buyer/seller will need to modify confidentiality agreement. See pp 276-288 of Acquisition Structure paper.

Letters of Intent

- Buyer may seek letter of intent that is generally not binding on either party (exceptions for expenses, confidentiality, good faith negotiation, etc.).
- The right words are critical in determining extent to which a letter of intent is non-binding. See *Global Asset Capital, LLC v. Rubicon*, C.A. No. 5071-VCL (Del. Ch. 2009) (discussed in note 10 on pp 8-9 of Exhibit C to *Acquisition Structure* paper).

Letters of Intent

Even if the letter of intent has unambiguous words to the effect that no binding contract will exist until a definitive agreement is signed, the conduct of the parties (particularly press releases and joint marketing efforts) can lead a trier of fact to find that the parties have entered into a definitive agreement.

Letters of Intent – Energy Transfer Partners

- *Energy Transfer Partners, L.P. (“**ETP**”) vs. Enterprise Product Partners, L.P. (“**Enterprise**”)* involved an action over an aborted joint venture.
- ETP claimed it had formed a joint venture with Enterprise to build an oil pipeline, and that Enterprise wrongfully terminated it.
- ETP and Enterprise had signed preliminary agreements which provided that there would be no partnership or joint venture formed unless and until definitive agreements were executed.
- Although no definitive joint venture agreement had been signed, the parties proceeded to spend time and money on the project and, reminiscent of *Texaco v. Pennzoil*, they communicated publicly that a joint venture had been formed and they marketed the pipeline to potential customers as if they had formed a joint venture.
- Notwithstanding the express provisions in preliminary agreements that nobody was bound unless and until definitive agreements were signed, ETP claimed, and the jury found, that the parties’ ensuing conduct served to form a Texas law partnership and that Enterprise breached its fiduciary duty of loyalty to ETP by taking the project to a competitor.
- The jury awarded $319 million plus attorneys fees to ETP.

Letters of Intent

- A letter of intent may be executed that includes a no-shop provision and gives the buyer adequate opportunity to conduct due diligence, but may accommodate buyer resistance to becoming contractually bound until it is ready to close.
- Conversely, the seller has an interest in not permitting extensive due diligence until the buyer is contractually bound.

Joint Ventures

- A joint venture is a relationship typically between two or three entities to accomplish a defined objective, and may take form of a contract or an entity. EGAN ON ENTITIES pp 25-27.
- Traditionally, a joint venture was thought of as limited purpose general partnership—but today a JV more likely an LLC. *Joint Venture* paper pp 5-9.

Joint Ventures

- Contributions to a joint venture can range from an established business unit with people and knowledge to cash or a license of IP (perhaps technology which one party has and needs funds and marketing muscle of other to develop; could be two parents putting together under-performing units to generally get off balance sheet).
- Expectations range from development of a product or project to a stand-alone business where the exit strategy is an IPO or sale of the joint venture. The exit strategy could also be dissolution of joint venture and distribution to partners.

Joint Ventures

- A joint venture may be contractual relationship or an entity.
- In the US, the LLC is now the entity of choice for joint ventures (principally limited liability with flexibility to be taxed as corporation or partnership and ability to limit fiduciary duties).
- *Dernick Resources Inc. v. Wilstein*, 312 S.W.3d 864 (Tex. App.—Houston [1st Dist.] 2009, no pet.), illustrates the dangers of using the term "joint venture" in contractual arrangements.

See EGAN ON ENTITIES p 26

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