MESSAGE FROM THE CHAIR

As the conclusion of my year as Chair of the Business Law Section draws near, I am so appreciative of the efforts of our Council members, committee chairs and vice chairs, and committee members. The fruits of their hard work include pending legislation in the 2009 Legislative Session, influence in discussions at the national level regarding potential amendments to Revised Article 9 of the UCC, and a new and improved website. Though still under construction, the new website (www.texasbusinesslaw.org) offers resources produced by the Section for its members, links to various resources for business lawyers, and enhancements relating to use of the website by committees. As noted elsewhere in this newsletter, the resources currently available to members at the website include weekly legislative monitoring reports. Further improvements to the website are underway to ensure that it is a user-friendly, current, and valuable source of information.

I hope that members of the Section who are attending the 2009 State Bar Annual Meeting in Dallas will take advantage of the CLE being presented by the Section in cooperation with the Corporate Counsel Section. Members of the Section who are registered for the Annual Meeting may attend the CLE at no additional charge and receive MCLE credit. Members of the Section who are not registered for the Annual Meeting may attend the Section's CLE at no charge without MCLE credit. The Section works throughout the year to provide opportunities for outstanding CLE for business lawyers at a discount to Section members. The Section co-sponsors numerous CLE programs in cooperation with other Sections of the State Bar, TexasBar CLE, and the University of Texas School of Law. Upcoming CLE programs are listed in this newsletter.

Congratulations are in order to two former chairs of the Business Law Section who have continued to render outstanding service to the Bar and have been recognized for their efforts by being selected to receive prestigious awards. George W. Coleman has been selected to receive this year's Dan Rugeley Price Memorial Award in recognition of Mr. Coleman's many years of outstanding service to the profession through Bar activities and prolific writing of CLE and other legal publications. This award will be presented to Mr. Coleman at the Texas Bar Foundation annual dinner on June 26. On Friday morning, June 26, at the Section's CLE program at the State Bar Annual Meeting, Byron F. Egan will be presented with the Franklin Jones Outstanding CLE Article Award. Mr. Egan is receiving this award for his CLE article entitled "Director Duties: Process and Proof," which was chosen by the State Bar College as the outstanding CLE article for 2008. Mr. Egan has also been selected to receive the 2009 Burton Award for Legal Achievement for his article entitled "Choice of Entity Decision Tree After Margin Tax and Texas Business Organizations Code" published in the Section's *Texas Journal of Business Law*. This award will be presented to Mr. Egan at the Tenth Anniversary Burton Awards Ceremony on June 15 in Washington, D.C. Mr. Egan previously won the Burton Award in 2005, 2006, and 2008.

I appreciate having had the opportunity to serve you as Chair of the Section for the 2008-2009 year. It has been a privilege and a pleasure. I hope you have a safe and enjoyable summer.

Kindest regards,

Beth Miller

Chair, Business Law Section, 2008-2009

2009 STATE BAR OF TEXAS ANNUAL MEETING

The State Bar of Texas Annual Meeting will be held at the Hilton Anatole, Dallas, Texas, on June 25-26, 2009. The Business Law Section and Corporate Counsel Section are co-sponsoring the following CLE programs at the Annual Meeting:

On Thursday, June 25th, the Business Law Section and Corporate Counsel Section will co-sponsor the following CLE presentations:

(i) The Five Hot Topics in Immigration Law and Employment Law in a Downturn, 8:45 AM to 9:45 AM;

(ii) Force Majeure and Impossibility of Performance, 9:45 AM to 10:30 AM;

(iii) Insurance Law, 10:30 AM to 11:15 AM;

(iv) Texas Access to Justice Corporate Counsel Pro Bono Award Presentation, 1:30 PM to 1:45 PM;

(v) Compliance Programs, 1:45 PM to 2:45 PM;

(vi) UCC Article 9 Update, 2:45 PM to 3:15 PM;

(vii) UCC Article 2 Update, 3:45 PM to 4:15 PM.

The Business Law Section will hold its section meeting at 4:15 PM on Thursday, June 25th after the conclusion of the CLE presentations.

On Friday, June 26th, the Business Law Section and Corporate Counsel Section will co-sponsor the following CLE presentations:

(i) Crisis Management, 9:00 AM to 10:00 AM;

(ii) Texas Business Organization Code Update, 10:00 AM to 10:45 AM;

(iii) Margin Tax; 10:45 AM to 11:15 AM.

For more information concerning the meeting, please see http://www.texasbar.com

Notice of Annual Meeting of the Business Law Section of the State Bar of Texas and Report of Nominating Committee

The annual meeting of the Business Law Section of the State Bar of Texas (the “Section”) will be held on June 25, 2009, at 4:15 p.m. at the Hilton Anatole, Dallas, Texas, in connection with the State Bar of Texas Annual Meeting. The business transacted at the meeting will include the election of Section Council members and voting on a proposed amendment of the Section bylaws. The proposed amendment would amend Article VIII, Section 1 of the bylaws to authorize the Section Council to determine the fiscal year of the Section. If approved by a majority vote of the members of the Section present at the meeting, the amendment will become effective when approved by the Board of Directors of the State Bar of Texas. The report of the Section Nominating Committee is set forth below.

A Nominating Committee was appointed by the current Chair of the Business Law Section Council, Elizabeth S. Miller, and consisted of Gail Merel, John C. Ale and Daryl B. Robertson. Ms. Miller appointed Ms. Merel to serve as Chair of the Nominating Committee.

The members of the Committee met via telephone conference call on two occasions and communicated numerous times via electronic messages. The members of the Committee discussed and contemplated various nominees for members of the Council and for the officers of the Business Law Section for the 2009-2010 year. The Nominating Committee determined to nominate the following persons for election by the members of the Business Law Section to a two-year term, commencing at the close of the Section's 2009 Annual Meeting, as members of the Council of the Business Law Section:

Roger A. Bartlett
Ronald Chichester
David E. Harrell
Carol Bavousett Mattick
Richard A. Tulli

The Committee also determined to nominate for election by the members of the Council the following as officers of the Business Law Section, to serve commencing at the close of the Council's meeting immediately following the Section's 2009 Annual Meeting:

Roger A. Bartlett, Chair
Richard A. Tulli, Chair Elect
David E. Harrell, Vice Chair
Jennifer C. Lindsey, Secretary-Treasurer

The foregoing concluded the business of the Nominating Committee for the 2009-2010 year.

FIDUCIARY DUTIES TO CREDITORS IN FIFTH CIRCUIT

By: Byron F. Egan, Robert G. Richardson, and Shakeeb U. Mir[1]

Jackson Walker L.L.P.

As companies spiral towards insolvency in the current tumultuous economic climate, the directors of these companies continue to be subjected to intense scrutiny, both by shareholders and creditors. In the recent case of *Torch Liquidating Trust v. Stockstill*,[2] the Fifth Circuit made it more difficult for the trustee of a corporation in a bankruptcy case to bring suit against the corporation's directors for breach of their fiduciary duties. Also significant is the Fifth Circuit's acknowledgement that under Delaware jurisprudence, a creditor of an insolvent corporation and even a corporation in the zone of insolvency has no direct claim against the directors for breach of fiduciary duty. The directors do not owe the creditors individually such duties. The creditors only have standing to bring a derivative lawsuit against the directors if they breached their fiduciary duties to the corporation while the corporation was insolvent. To have the right to bring a "derivative" lawsuit, the corporation must have refused unjustifiably to bring the action.

In 2005, after it had become insolvent, Torch filed for Chapter 11 bankruptcy and Torch Liquidating Trust was created to hold all property of the debtor's estate, including causes of action against its directors and officers, if any, for breaching their fiduciary duty to Torch. In 2007, as the authorized representative of the Trust, the Trustee filed a complaint against Torch's former directors and officers. The original complaint alleged that while Torch was in the zone of insolvency and insolvent, the directors and officers breached their fiduciary duties of candor owed to Torch's creditors. The Trustee contended that the directors and officers painted too rosy a picture of Torch's financial position which induced the creditors to extend credit to Torch which they would not otherwise have done.

Gheewalla Bars Direct Creditor Claims

After the Trustee's lawsuit was filed, the Delaware Supreme Court issued its opinion in *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*,[3] which 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 have standing to maintain *derivative* claims against directors on behalf of the corporation for breaches of fiduciary duties." In the aftermath of *Gheewalla*, the Trustee filed an amended complaint, which asserted that he was also bringing derivative claims on behalf of shareholders. The Trustee alleged that "[t]his matter is in the nature of a derivative suit in that plaintiff sues on behalf of the shareholders and creditors alike of [Torch]" and any recovery is to become property of the Trust for distribution according to the Plan.

The defendants filed a motion to dismiss under Rule 12(b)(6), asserting that the Trustee lacked standing to bring the suit, that Delaware's business judgment rule applied to preclude the directors' liability, and that the Delaware General Corporation Law § 102(b)(6) exculpatory provisions in Torch's certificate of incorporation shielded the directors from liability for the alleged breaches of their fiduciary duties. The District Court granted the motion, holding that plaintiff Trustee lacked standing to assert many of its claims, which the District Court interpreted as continuing to allege direct creditor claims barred by *Gheewalla*, and, to the extent any of the claims were properly derivative, that Delaware's business judgment rule defeated those claims.

Fifth Circuit Applies Delaware Law and Holds Failure to State a Claim

The Fifth Circuit, applying Delaware law because the company was incorporated in Delaware, affirmed the dismissal of the amended complaint, but on a different basis. Disagreeing with the District Court, the Fifth Circuit held that the Trustee did have standing to bring *direct* claims on behalf of the Trust (i.e., claims formerly owned by Torch) against the directors and officers for injuries to Torch. In its discussion, the Court mentioned that the District Court may have incorrectly concluded that the Trustee *would* have had standing to bring *derivative* claims on behalf of creditors and shareholders. However, the Fifth Circuit notes that this conclusion is wrong, as there was no assignment of claims to the Trust by the creditors or shareholders, only an assignment from the debtor Torch to the Trust. Accordingly, the Trustee could not bring claims (if any existed) that were owned by the creditors.

Although the Trustee was found to have standing to bring claims on behalf of the corporation because those claims had been expressly assigned to the Trust, the Fifth Circuit held the plaintiff Trustee had nonetheless failed to allege the necessary elements of a claim for any breach of fiduciary duty owed by the directors and officers to Torch:

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 appears 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 Court went on to criticize the Trustee for attempting to bring the suit on behalf of the creditors stating, "This ill-conceived pleading posture distracts from Bridge Associates' standing as trustee to bring a direct suit on the Trust's behalf for Torch's claims against the Directors." In the Court's view, "plaintiff is not attempting to recover for injury to Torch but instead attempting yet again to repackage creditor claims against the directors and officers that are defunct under Delaware law after *Gheewalla*."

Conclusion

The *Torch* case reinforces the Delaware Supreme Court's ruling in *Gheewalla*, which bars direct claims by creditors based on a theory that the directors and officers had breached a fiduciary duty owed to the creditors. If the creditors have no direct claims for breach of fiduciary duty, then the directors and officers must not owe the creditors individually any fiduciary duties, even when the company is insolvent or in the zone of insolvency. Trustees in bankruptcy may bring direct claims on behalf of a corporation, but are unable to bring derivative lawsuits alleging claims of creditors and shareholders.

I WOKE UP THIS MORNING AND I'M IN DEFAULT. WHAT DO I DO NOW?

By: Sue P. Murphy and Scott G. Night
Haynes and Boone, LLP

Background:

Many companies entered into their existing debt agreements before the current economic crisis. As a result, the financial covenants in their debt agreements were based upon financial projections and assumptions that are no longer appropriate or attainable. Therefore, more companies are waking up to face defaults under financial covenants that they never anticipated and are left wondering what do they do next.

Not that long ago, ample credit was available to companies looking to finance their businesses. Banks, finance companies, private equity funds, and other lenders competed to make loans (both traditional senior debt and mezzanine or subordinated debt) and wooed prospective borrowers. With the current economic crisis, fewer lenders are marketing financing products. A borrower who was once a "prized" customer and could dictate its own terms to its lender will likely find itself with fewer options when facing a potential default and will be forced to work with its existing lender to resolve the situation.

Potential Defaults and Other Issues:

Most debt agreements include financial covenants that limit leverage or measure the borrower's ability to satisfy interest expense, debt service, and other charges or expenses. A typical leverage test compares indebtedness to earnings before interest, taxes, depreciation, and amortization ("***EBITDA***"). A typical operating test compares EBITDA to interest expense or overall debt service. Such covenants are usually tested on a quarterly basis for the trailing four (4) quarter period, but sometimes these ratios are measured as often as monthly for the trailing twelve (12) month period. Many debt agreements also have limitations on borrowings tied to a "Borrowing Base," which typically consists of accounts receivable, inventory, or other assets.

If a borrower experiences a downturn in its operating performance (because of reduced revenues, increased costs, or both) or has had to increase its borrowings to support its operations, then that borrower could find itself unable to satisfy the financial covenants in its debt agreements. Some companies may also see their Borrowing Base availability reduced as a result of lower receivables, a greater number of "aged out" receivables, concentration limitations, or credit quality issues with respect to underlying account debtors, which would have the effect of limiting or eliminating additional advances.

If a borrower believes that it is in default or that a default is likely, then it should carefully review its debt agreements. Almost every credit agreement provides that the borrower cannot request advances if a default or event of default exists. Most debt agreements require the borrower to notify the lender of the occurrence of an event of default or a potential default. In addition, the occurrence of a default may trigger restrictions on the borrower's ability to take certain actions such as paying dividends, repurchasing stock, prepaying indebtedness, or other actions outside the ordinary course of business. Borrowers should also consider whether a default under one of its debt agreements creates disclosure requirements under applicable laws (*e.g.*, SEC reporting) or results in a cross-default under other agreements.

Even where the borrower is still in compliance with the financial and other covenants in its debt documents, most debt agreements have broad representations and warranties that the borrower must make as a condition to borrowing. For example, most credit agreements require the borrower to represent and warrant that there has not been a material adverse change in the borrower's assets, results of operations, financial condition, or prospects (a "***MAC***") as a predicate to any new advance. In addition, some debt agreements include an event of default if there has been a MAC. Whether a MAC has occurred depends upon an intense, subjective examination of the precise language of the MAC and the underlying facts and circumstances. Historically, lenders have been reluctant to rely upon a MAC, in and of itself, as a basis to refuse to make advances or to declare an event of default. In today's economic climate, more lenders may be willing to declare that a MAC has occurred.

Approaching the Lender:

Loan officers hate surprises. In most instances, therefore, borrowers should notify their loan officers as early as possible if the borrower knows or expects that it will not be able to comply with its loan documents. Although helpful, borrowers do not need to have a solution before approaching their lenders about an impending default. They do, however, need to be able to explain to their lenders what caused the default. Borrowers cannot expect their lenders to waive defaults or reset covenants without understanding what happened, why it happened, whether things are likely to get better or worse, and when it is likely that the borrower will be able to get back in compliance.

Note that notifying your loan officer of a default or the possibility of a default is not without risk or consequences. Once you notify a lender of an existing or impending default, the lender likely has the right to no longer advance funds under a revolving credit or other advance type facility. In addition, the borrower may lose the right to more favorable pricing options such as LIBOR. Even worse, the lender may have the right to impose a default rate. Of course, notifying the lender of the default could lead the lender to take enforcement actions such as cutting off access to bank accounts, exercising setoff rights, accelerating maturity of the loan, or proceeding to enforce liens and security interests in collateral. If a default has not yet occurred, the lender may consider the borrower's disclosure to be a MAC (as described above).

Potential Solutions and Lender Requirements:

The potential business solutions to deal with a financial covenant violation vary depending upon the nature and severity of the default. Typical remedial actions that the borrower or the lender may propose include:

- Restructuring operations
- Changing business model
- Cutting costs
- Selling assets
- Reducing debt
- Raising equity or subordinated debt
- Refinancing the subject facility or other facilities

Typical changes in the loan documentation to address these types of defaults include:

- Resetting financial covenants based on updated projections
- Adjusting the calculation of the covenants to account for non-recurring items
- Adjusting Borrowing Base availability

In exchange for a waiver or covenant relief, lenders may require one or more of the following:

- Reduction in the facility size
- Payment of waiver or amendment fees
- Increase in interest rates and fees
- Additional credit support (e.g., additional collateral (if available), personal guarantors, etc.)
- Prohibition of, or restrictions on the borrower's ability to make, certain types of payments (e.g., management fees, dividends, stock repurchases, prepayment of indebtedness, payments on subordinated debt, etc.)
- Further restrictions on other actions (e.g., incurrence of otherwise permitted debt)
- Additional collateral restrictions (e.g., establishing lockbox arrangements)
- More frequent or additional financial information or reporting
- New or more frequent collateral audits or appraisals
- Engagement by the borrower of a restructuring officer or engagement by the lender (at the borrower's expense) of financial or other consultants
- Release by the borrower of the lender from any claims

In most circumstances, lenders desire to resolve the problem and retain the business relationships they have established with their borrowers (particularly where the relationship has been developed over a period of many years). In some instances, however, the lender's only objective will be to get the loan repaid as soon as possible. In those instances, the loan may be moved from the historical relationship officer to a “special asset” or workout officer who typically has less loyalty to the borrower.

In light of current economic climate, a borrower in such a situation may have limited refinancing alternatives. As such, the borrower will have the unenviable task of having to convince its lender that working together will maximize the lender’s prospects for repayment and that the alternatives (remedies exercises, litigation, bankruptcy, etc.) are less desirable to everyone involved.

FRANCHISING: STRATEGIES FOR WEATHERING DIFFICULT ECONOMIC TIMES

By: Will Woods and Ann Hurwitz
Baker Botts LLP

There is a level of interdependence in the franchise relationship not present in other types of business relationships. Given the extremely challenging economic climate and the impact that it is having, and will have, on the revenues and overall profitability of businesses generally, it is critical for franchisors to plan now for dealing with distressed franchisees. This article examines problems that are likely to arise with franchises during difficult economic times as well as practical strategies to address those problems.

A. Typical Problems Arising in Franchise Relationships During an Economic Downturn

Although defaults and other issues under franchise agreements can and do arise even in the best of times, the likelihood that a greater proportion of franchisees will experience difficulties and ultimately violate the terms of their franchise agreements is greater during times of economic distress. Franchisors must be attuned to potential defaults (particularly those that can have a lasting negative impact on the brand) and warning signs and proactively monitor their franchisees’ financial condition and operations so that they can be in a better position to deal with problems as they arise. Of course, it is often the case that the earlier problems are identified the more likely a viable solution can be devised to resolve the issue and minimize acrimony between the franchisor and franchisee.

1. *Failure to Timely Open for Business*

Franchise agreements generally contain provisions that require the franchisee to complete construction or other renovation requirements and open for business within a certain period of time after the franchise agreement is executed. Given the current difficulty of obtaining financing (even for well-qualified borrowers) and the general market uncertainty, more franchisees may not be able to meet opening deadlines or they may simply delay moving projects forward until some certainty returns to the markets. Franchisors should have systems in place to monitor construction and opening deadlines and engage in open dialogue with franchisees that are not making adequate progress.

2. ***Improvements and Upgrades***

In the highly competitive market of recent years, many companies have enhanced brand standards and have required that their franchisees make significant upgrades to their businesses. Although franchise companies have legitimate operational and competitive reasons to require improvements and upgrades, these requirements often come at significant up-front, and sometimes ongoing, cost to franchisees. In the current economic environment, franchisees may have difficulty obtaining appropriate financing for improvements and upgrades, particularly those that involve significant capital expenditures. Franchisors should carefully consider which improvements and upgrades make sense to require in the current environment and address situations in which franchisees are not meeting those requirements.

3. ***Standards Violations***

In light of falling revenues and overall profitability, franchisees may be tempted to postpone regular maintenance work or otherwise cease complying with system standards. Maintaining the business and meeting operational standards is, obviously, a core obligation of the franchisee. Any failure to comply with standards should be taken very seriously since failure to comply with standards can have a lasting effect on the brand as a whole. Further, noncompliance with standards could signal deeper problems with a particular franchisee, such as mismanagement or financial difficulties. Franchisors should monitor compliance with standards through periodic quality assurance evaluations and inspections. Additionally, complaints from customers should be investigated.

4. ***Payment Defaults***

Failure to pay amounts due under the franchise agreement such as royalties, advertising fees, and other amounts is the most obvious indication that a franchisee may be in distress. While delays in payment are not uncommon, a systematic failure to pay (or pay on time) could indicate trouble. Franchisors must monitor payment patterns and deal with payment issues quickly. Additionally, franchisors should enforce the financial reporting requirements of the franchise agreement and analyze the information and trends in those reports in an effort to identify potential problems early.

B. What Can and Should a Franchisor Do?

Franchisors should proactively plan for franchisee defaults in a manner that is both fair to franchisees and that protects the brand—not simply respond when problems arise. As a general matter, franchisors must always consider the effect of any plan for addressing defaults with a particular franchisee on the system as a whole and on other franchisees. “Going light” on one franchisee without a demonstrable business justification, while strictly enforcing the terms of the franchise agreement on other franchisees with respect to the same or similar defaults, can create resentment within the franchisee community or could be a violation of applicable anti-discrimination laws, and, ultimately, can harm the brand as a whole.

1. ***Understand the Franchisor's Rights and Remedies and any Restrictions on Their Exercise.***

A critical first step in addressing defaults under a franchise agreement is to analyze the franchisor's rights and remedies under the franchise agreement and applicable law. A failure to act in accordance with the franchisor's contractual rights and the law can result in exposure to liability such as breach of contract claims and actions by franchisees and regulators under applicable statutes.

a. **Under the Contract**

Courts are generally willing to enforce a franchisor's right to take action against franchisees (including terminating franchisees) if the franchise agreement clearly gives the franchisor the right to take such action and the facts support the franchisor's action.[4] However, franchisors must understand what the franchise agreement says and proceed cautiously. A failure to do so could result in a breach of contract or wrongful termination claim.[5]

b. **Franchise Relationship Laws**

Approximately twenty states have franchise relationship laws which generally require that franchisors comply with substantive and procedural requirements with respect to certain aspects of their relationships with franchisees, including termination, nonrenewal, and transfers.[6] For example, the California Franchise Relations Act provides that the franchisor must have "good cause" in order to terminate a franchisee and that the franchisor must give the franchisee written notice and a "reasonable opportunity" to cure most defaults prior to terminating.[7] In addressing a default situation, franchisors must, therefore, determine whether there are any applicable franchise relationship laws and comply with those laws, regardless of what the franchise agreement provides, before issuing any warning, default or termination notices to franchisees.

Additionally, franchise relationship laws in sixteen states contain some form of anti-discrimination provision.[8] Generally, those provisions prohibit a franchisor from discriminating "unfairly" in its dealings with franchisees.[9] Most of these provisions specifically permit a franchisor to treat its franchisees differently, provided there is some reasonable basis for doing so (e.g., the franchise is granted at a different time, the concept is in development or is experimental, or there are other reasonable distinctions and the disparate treatment is not arbitrary). Particularly in light of these anti-discrimination provisions, franchisors should treat "similarly situated" franchisees consistently in the context of addressing violations of the franchise agreement.[10]

2. ***Modify "standard' Franchise Agreement Terms to Reflect the Economy's Impact***

Franchisors should consider whether, in light of the current economic climate and the state of the credit markets, certain standard provisions of the franchise agreement should be modified at the inception of the relationship based on the particular franchisee's circumstances. For example, franchisors should take into consideration the prospective franchisee's likelihood of obtaining financing and set realistic timelines for opening, even if that means drawing out the standard construction/opening timelines.

Franchisors may also consider providing the franchisee with a termination right in the event that financing cannot be obtained and/or construction work does not begin by a certain date. Any such termination right should be tightly drafted so that there is a "window" during which the franchisee may terminate upon written notice, and consideration should be given to whether a termination fee will be required in connection with the exercise of the termination right and whether the franchisor will require the franchisee to sign a general release or meet any other conditions upon termination. Finally, in appropriate circumstances, a royalty ramp-up may be considered as a way to provide relief to the franchisee in the initial start-up period.

3. ***Quality Assurance Programs/Inspections to Identify and Monitor Problems***

A quality assurance program is critical to any franchise system as a means to monitor franchisee operations and ensure that franchisees comply with system standards. Quality assurance programs take on heightened importance during difficult economic times when franchisees may either be in distress or are cutting costs in order to maintain profitability. Conducting periodic quality inspections (either announced or unannounced) of franchised locations on a regular basis should be part of a comprehensive quality assurance program. Franchisees that are conditioned to expect regular inspections are oftentimes more likely to consistently maintain standards, and for those franchisees that do not maintain standards, inspections are a good way for franchisors to identify and address issues with franchisees.

4. ***Deadline Extensions***

Despite a franchisor's best efforts to set reasonable deadlines, franchisees may have difficulty meeting deadlines provided for in the franchise agreement due to a failure by the franchisee to obtain financing or an unwillingness to meet those deadlines due to the business's performance or the general state of the economy.[11] Franchisors must consider carefully whether it is appropriate under the circumstances to extend deadlines.

If the failure of a franchisee to meet deadlines is due to circumstances over which the franchisee has little or no control (e.g., the lack of available credit to a well-qualified franchisee that it using its best efforts to obtain financing), the franchisor may be more willing to make adjustments to deadlines. However, if a franchisee is capable of meeting deadlines and chooses not to do so due to the economy or other factors or if the failure to meet a deadline will have a significant adverse impact on the brand, the franchisor may elect to enforce the deadline without an extension. Discerning the reasons for missed deadlines and the appropriate action to take is a sometimes difficult, but critical, task.

5. ***Temporary Royalty/Advertising Fee Relief***

In some cases, a royalty abatement or a reduction in the royalty percentage for a limited period of time may be appropriate. Alternatively, the franchisor may wish to permit a franchisee to redirect of a portion of royalties to increased local advertising expenditures or advertising fund contributions in order to increase brand awareness and drive revenue if the business's performance is an issue.

Obviously, a decision by a franchisor to decrease required royalties must be taken carefully as it will necessarily have an adverse impact on the franchisor's revenues, even if only for a limited period of time. The deferral period and repayment terms should be clearly addressed. During the deferral period, the franchisee should continue to submit all required reports and its responsibility to operate in accordance with the franchise agreement and system standards should be a key condition to the agreement to defer royalties. Franchisor should also consider restricting payments of any administrative, management or other similar fees by the franchisee during the deferral period, especially if such payments are made to entities affiliated with the franchisee.

Franchisees that have proven themselves as capable operators and that are in compliance with their franchise agreement but that may need limited financial relief in order to make it through temporary difficulties may be good candidates for this type of arrangement. Ultimately, the franchisor has to assess whether this type of relief will have the effect of improving the likelihood of the franchisee's success in operating under the brand.

6. ***Leverage Supply Arrangements***

In an economic downturn suppliers may be more willing to negotiate lower prices or re-negotiate existing supply arrangements for products and services that they supply to franchisees. Franchisors should be proactive in identifying this and other opportunities for maximizing cost savings for franchisees. Taking advantage of cost saving opportunities now can not only assist those franchisees that are currently struggling but can also position the system well for an economic recovery.

7. ***Initiatives to Increase Revenues***

Franchisors should consider alternatives to drive business to franchised locations, such as increasing sales training at the unit level, offering franchisees the opportunity to participate in special customer incentive programs, including limited pricing promotions, and reallocating advertising expenditures to areas that have been hit harder by the recession.

C. Conclusion

Although the economy offers many business challenges, careful, proactive management of those challenges can help franchised businesses not only weather those challenges but emerge stronger and well-positioned for future growth.

New Statutory Organization for Texas Privacy Laws Takes Effect April 1, 2009

By: Christopher J. Volkmer
Volkmer Law Firm LLC

Texas has a number of laws pertaining to access, use, protection and disposal of personal information. Most of these laws had been placed in scattered sections of Title 4 (Miscellaneous Provisions) of the Business and Commerce Code. In some cases, the section numbers were overlapping, and there was no overall organization to these privacy-related laws.

In the 2007 legislative session, the Texas legislature took steps to reorganize the Business and Commerce Code, and in particular the laws that had been placed under Title 4. The statutes relating to business records and personal information under Title 4 were repealed, and have been placed under Title 5 (Regulation of Businesses and Services) and the new Title 11 (Personal Identifying Information) of the Texas Business & Commerce Code. The repeal date of the Title 4 provisions and the effective date of the new provisions is April 1, 2009. Texas lawyers will have to update references to these laws in litigation pleadings and briefs, agreements, and compliance advice. The following is a summary of the provisions of Title 11 and the prior provision under the repealed Title 4 provisions:

Business & Commerce Code Personal Information Title Changes

New Title 7 or 11	Old Title 4	Summary
§72.001-004 Disposal of Certain Business Records	§35.48	· Business record includes electronic, printed and recorded materials · Can destroy business records after 3 years unless another law or rule prescribes a different period · Destruction of personal identifying information requires making the records unreadable · Does not apply to financial institutions under GLBA or covered entities under the Insurance Code

New Title 7 or 11	Old Title 4	Summary
§72.051 Deletion of Certain Records or Information Related to Customers' Checks	§35.62	· A business must remove information concerning a dishonored check if customer presents proof that the check was unauthorized · Enforcement is by the Attorney General
§501.001-002 Confidentiality of Social Security Numbers	§35.58	· Generally prohibits (i) using SSNs in public communications, (ii) using SSNs in customer access devices, (iii) requiring transmission of SSNs without security or encryption, (iv) using a SSN as a means to access an internet web site, or (v) printing a SSN in mailed material (except in limited cases) · Exceptions include FOIA requests and open records, internal verification use, court records, and as permitted by Chapter 51 of the Education Code
§501.051-053 Privacy Policy to Protect Social Security Numbers	§35.581	· A business must adopt and make available a privacy policy if the business requires an individual to provide a SSN to obtain goods or services or enter into other transactions · Does not apply to entities covered by GLBA · Elements of policy are listed in the statute · Enforcement is by the Attorney General or the county prosecuting attorney
§501.101-102 Other Restrictions to Protect Driver's License and Social Security Numbers	§35.581*	· A merchant or its contractor that requires a DL number or SSN in connection with the return of merchandise must limit use solely to identify the customer if the customer does not have a valid receipt or to investigate fraud in the return of merchandise · DL or SSN information can be retained only for six months · Enforcement is by the Attorney General or the county prosecuting attorney
§52.001	§35.60	· Requires restaurants and bars that accept credit or debit cards to post signs warning employees of penalties for unauthorized use of card numbers

New Title 7 or 11	Old Title 4	Summary
Warning Sign About Identity Theft for Restaurant or Bar Employees		· Misdemeanor; can cure within 48 hours of citation
§502.002 Business Receipt Containing Credit Card or Debit Card Information	§35.61	· Persons who accept credit cards or debit cards cannot print more of the card number than the last 4 digits on any transaction receipt or similar document · Does not apply if the “sole means” of recording the card is by imprint · Sellers or lessors of machines used to print receipts must inform notice of this requirement to the end user Enforcement by Attorney General; class actions not permitted
§502.003 Delivery of Check Form	§35.395	· Requires a check form provider to give the person ordering checks an option to have delivery require the signature of the addressee, if it is available · Persons providing for the delivery option and courier that is used may be liable if signature is not obtained when requested and a loss occurs Enforcement by the Attorney General
§503.001 Capture or Use of Biometric Identifier	§35.50	· Biometric Identifiers defined as a retina or iris scan, fingerprint, voiceprint, or record of hand or face geometry · Requires the individual be notified before identifier is captured; requires consent of the indivisual to capture the identifier · Cannot disclose or sell biometric identifiers except with consent, to complete a transaction, as permitted by law, or disclosure to law enforcement Enforcement by the Attorney General
§504.001 Prohibited Use of Crime Victim or Motor	§35.54	· Prohibits obtaining crime victim or motor vehicle accident information from a law enforcement agency to solicit business from persons involved or to sell to third parties

New Title 7 or 11	Old Title 4	Summary
Vehicle Accident Information		· Attorney General may enforce as a deceptive trade practice under §17.47; also a misdemeanor, fourth conviction is a felony
§521.001-152 Identity Theft Enforcement and Protection Act	§48.001 – 203**	· Prohibits obtaining, possessing or transferring personal identifying information of another person without such person's consent and with the intend to obtain a good, service, insurance, credit, or other thing of value · Requires businesses to implement and maintain reasonable procedures to protect sensitive personal information (name identifier plus SSN, DL or other government number, or account or access code to a credit or debit card) and to properly destroy same · Describes the conditions under which notice is required to be given to affected persons in the event of a breach of system security · Provides that an individual can obtain a court order to declare an individual as a victim of identity theft · Enforcement by the Attorney General; civil penalty of at least $2,000 but not more than $50,000 for each violation; injunctive relief can be sought
§522.001-002 Identity Theft by Electronic Device	§35.60	· Prohibits use of a scanning device or re-encoder to access payment card magnetic strip information
§523.001-003 Provisions Relating to Victims of Identity Theft	§35.585, §35.59, §35.591	· A person notified that an individual is a victim of identity theft cannot deny the individual an extension of credit solely because of the identity theft victim status · Requires a person having notice of a security alert under §20.032 may not grant an extension of credit or permit purchase of goods or services without verification of consumer's identity, including contacting the consumer by telephone · Requires financial institution to process identity theft checks as forgeries if the customer is a victim of identity theft closes the account and provides the financial

New Title 7 or 11	Old Title 4	Summary
		institution with notice of the reason for closing and a copy of the criminal complaint

*section heading editorially supplied by publisher of statutes and is duplicative of prior statute number

**The legislature had enacted three separate laws under the designation of §48.001: the Identity Theft Protection Act, the Consumer Protection Against Computer Spyware Act, and a section entitled "Internet Fraud" which covers the use of fraudulent web pages and email. The Spyware Act is now codified at Section 324-001-102 of the Texas Business and Commerce Code. The section on Internet Fraud is now codified at Section 325.001-004 of the Texas Business and Commerce Code.

One area where some confusion may still exist is in the area of retention and disposal of business records. This subject is addressed in both Section 72.001-004 of Title 5 and in Sections 521.002 and Section 521.052 of Title 11. The former uses the defined term "personal identifying information" and the latter uses the defined term "sensitive personal information" and the definitions are similar but not identical. Moreover, the Title 5 provision deals with the use of a third party to comply with the records destruction provision of that statute, but the same provision does not appear in the Title 11 section dealing with records destruction.

Texas attorneys should expect additional laws from the 2009 legislative session that affect the privacy and data protection rights of citizens and obligations of businesses, and add to the growing body of privacy law in Texas.

Committee updates:

E-Commerce Committee Update

The Spam Subcommittee of the E-Commerce Committee worked on the bill analysis of the Anti-Botnet Bill currently under consideration by the State Legislature. The bill analysis is as follows:

Under current law, computers are not prohibited from being used in a botnet. A botnet is a collection of compromised computers (called "zombies" in this bill). Zombies are used to perpetuate cybercrime. Botnets are increasingly used by cybercriminals to

- Send spam email, messages containing viruses;
- Send software that is damaging to other computers;
- Steal personally identifiable information; or,

- Make other computer resources unavailable to owners or users of the computer or the network.

Most compromised computer owners or users are unknowing and unwitting victims. The FBI reported over 1 million victims of botnet activity in 2007. E-commerce is quickly becoming the next frontier of international business and is being threatened by the use of botnets. Symantec, a computer security company, reported observing an average of 57,000 bots (individually compromised machines also known as zombies) per day during the first half of 2006. During this period, Symantec discovered a total of 4.7 million computers actively being used in botnets.

2009 Session of the Texas Legislature

Committees of the Section have prepared three bills that, through the efforts of the Texas Business Law Foundation, have been introduced in and have been, or are being, considered by the current Texas Legislature. Two of the bills contain amendments primarily to the Texas Business Organizations Code (the "TBOC"), and one proposes to amend the Texas Business and Commerce Code (the "TBCC").

Senate Bill 1442 contains various amendments primarily to the TBOC to:

- Reflect or correspond to changes in the law adopted by the Texas Legislature since 2006, including (among other things) the previous changes to the franchise or margin tax and to the assumed-name provisions of the TBCC.
- Make certain substantive changes to the TBOC, including (among other things) authorizing the formation of limited liability companies that have series of members, managers, membership interests, or assets; authorizing conversion and continuance transactions; authorizing a for-profit corporation to adopt a procedure to deal directly with the beneficial owner of its shares; and permitting a beneficial owner of an ownership interest entitled to dissenters' rights to file a petition for appraisal.
- Make certain technical and clarifying amendments to the TBOC, including (among other things) conforming the language of the TBOC to the language of its source statutes in certain instances where the TBOC's language unintentionally deviated; clarifying language of certain provisions in response to recent court interpretations; and expressly stating certain authority of and requirements relating to entities that have been implicit in the TBOC and its source statutes.

Senate Bill 1442 has been passed by both the Senate and the House, with one small amendment added and has been signed by the Governor.

Senate Bill 1773 contains amendments to Chapter 101 of the TBOC, which applies to limited liability companies formed since January 1, 2006, and to the Texas Limited Liability Company Act (the "TLLCA"). The amendments respond to the trend of court cases that allow for some limited piercing of the liability veil of limited liability companies. The amendments provide that the statutory provisions relating to veil-piercing with respect to a for-profit corporation would also apply to veil-piercing with respect to limited liability companies. In particular, Sections 21.223

through 21.226 of the TBOC would apply to a limited liability company and its members, owners, assignees and subscribers that are subject to the TBOC, and Article 2.21 of the Texas Business Corporation Act would apply to a limited liability company subject to the TLLCA. Senate Bill 1773 has been passed by the Senate and reported favorably by the House Business and Industry Committee.

Senate Bill 28 proposes to add to the TBCC a new Section 324.055 that:

- Prohibits a person from knowingly causing or offering to cause a computer to become a "zombie" or part of a "botnet." A "zombie" is a computer that has been compromised, without the consent of its owner or operator, to give access or control to a program or person other than the computer's owner or operator, and a "botnet" is a collection of zombies. Among the prohibitions is the use of a zombie or botnet to send unsolicited commercial e-mail messages, damage or disrupt a computer system or network, collect personally identifiable information, or effect any other unauthorized purpose.
- Provides for any person adversely affected or the Attorney General to bring a civil action for injunctive relief or actual damages (with a minimum of $100,000 for each violation or zombie), or both.

Senate Bill 28 has been passed by the Senate and reported favorably from the House Technology, Economic Development, and Workforce Committee.

These bills, as well as various other bills introduced in the current Texas Legislature that may be of interest to members of the Section, are described in the weekly legislative monitoring reports prepared for Section members by George Christian. The reports are available to Section members on the Section's new website at http://www.texasbusinesslaw.org/resources/2009-legislative-monitoring.

Upcoming CLE Programs

The Section sponsors or co-sponsors a number of continuing legal education seminars each year, including a free CLE program to its members every year at the State Bar of Texas Annual Meeting. In some instances, discounts on registration fees are available to members of the Section. Upcoming CLE programs include the following:

Choice of Entity in Troubled Times

- Hyatt Hill Country Resort & Spa, San Antonio, Texas—May 22, 2009
- Norris City Centre, Houston, Texas (video replay)—July 2, 2009
- Cityplace Conference & Event Center, Dallas, Texas (video replay)—July 10, 2009
- Presented by State Bar of Texas
- Section members get $25 discount

Free CLE at State Bar of Texas Annual Meeting

- Hilton Anatole, Dallas, Texas
- June 25-26, 2009
- Presented jointly by the Business Law Section and the Corporate Counsel Section.
- Admission is free to all members of either section.

Partnerships and Limited Liability Companies

- Four Seasons Hotel, Austin, Texas—July 23-24, 2009
- Belo Mansion, Dallas, Texas (video replay)—October 8-9, 2009
- Presented by University of Texas CLE
- Section members get $30 discount

Advanced In-House Counsel Course

- Four Seasons Hotel, Houston, Texas—July 30-31, 2009
- Cityplace Conference & Event Center, Dallas, Texas (video replay)—September 3-4, 2009
- Presented by State Bar of Texas
- Section members get $30 discount

Advanced Business Law Course

- Norris CityCentre, Houston, Texas—October 22-23, 2009
- Video replay not yet set
- Presented by State Bar of Texas
- Section members get $50 discount

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[2] No. 08-30404, ____ F.3d ____ (5th Cir. Feb. 23, 2009).

[3] 930 A.2d 92 (Del. 2007).

[4] *See, e.g.,* Int'l House of Pancakes, Inc. v. McNeil, 2007 U.S. App. LEXIS 4840 (4th Cir. Mar. 2, 2007) (granting IHOP summary judgment on its breach of contract claim, holding that a failure of the franchisee to maintain sales records for 36 months as required by the franchise agreement was an appropriate basis for termination), Maple Shade Motor Corp. v. Kia Motors Am., Inc., 260 F..App'x. 517 (3d Cir. 2008) (holding that Kia had good cause for terminating the franchise agreement in connection with Maple Shade's failure to build a separate showroom for Kia's vehicles as agreed-upon under the franchise agreement), Shaffer v. Domino's Pizza, Inc., 2006 WL 355022 (E.D.N.Y. Feb. 15, 2006) (finding that Domino's properly terminated the franchise agreements in connection Shaffer's failure to maintain liability insurance), *but see,* Magna Cum Latte, Inc. v. Diedrich Coffee, Inc., 2007 Bankr. LEXIS 4265 (Bankr. S.D. Tex. Dec. 17, 2007) (holding that the franchisor's termination of the franchise agreement due to the fact that the head lease, which was held by the franchisor, was not renewed was improper and that the failure of the franchisor to renew the lease was a breach of the implied duty of good faith and fair dealing under California law, even though the franchise agreement expressly permitted termination in that event and the franchisor had no express obligation to renew the lease).

[5] *See, e.g.,* Voice-Tel Enterprises, Inc. v. JOBA, Inc., 258 F. Supp.2d 1353 (N.D. Ga. 2003) (holding that franchisees did not materially impair franchisor's trademark, within meaning of provision authorizing termination of franchise agreement.) and LaGuardia Assocs. v. Holiday Hospitality Franchising, Inc., 92 F.Supp.2d 119 (E.D.N.Y. 2000) (finding that since franchisor had repeatedly waived past payments defaults, franchisor could not terminate the franchisee agreement for franchisee's failure to comply immediately and strictly with payment terms without first providing sufficient notice and a reasonable time for franchisees to alter their conduct.).

[6] Alaska, Arkansas, California, Connecticut, Delaware, Hawaii, Illinois, Indiana, Iowa, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, Rhode Island, South Dakota, Virginia, Washington and Wisconsin.

[7] Cal. Bus. & Prof. Code § 20020 (West 2009).

[8] Arkansas, California, Connecticut, Delaware, Hawaii, Illinois, Indiana, Iowa, Michigan, Minnesota, Nebraska, New Jersey, Tennessee, Virginia, Washington, and Wisconsin

[9] *See, e.g.,* Indiana Deceptive Franchise Practices Act, Bus. Franchise Guide (CCH) ¶4140.02; Hawaii Franchise Rights and Prohibitions Law, Bus. Franchise Guide (CCH) ¶4110.01; Washington Franchise Investment Protection Act, Bus. Franchise Guide (CCH) ¶4470.01.

[10] Generally, case law also supports the position that franchisors may discriminate among franchisees, so long as the discrimination is not "unfair" or is justifiable. *See, e.g., Canada Dry Corporation v. Nehi Beverage Co.*, 723 F.2d 512 (7th Cir. 1983) ("proof of 'discrimination' requires a showing of arbitrary disparate treatment among similarly situated individuals or entities"); *McDonald's Business Facilities Corp. v. Werve*, 392 N.W.2d 130 (Wisc. Ct. App. 1986); *see generally* J. Michael Dady and Arthur L. Pressman, *Treating Franchisees Differently: "Hanged" if You Do, "Hanged" if You Don't?!*, ABA Forum on Franchising (October 1998).

[11] *See* Torto Wheaton Research/Dodge Construction/Smith Travel Research Construction Pipeline Report for November 2008, which shows a 75% increase over November 2007 in the number of guestrooms in the construction pipeline that have been abandoned.