The Newsletter of the Business Law Section

Message From the Chair

This newsletter reports on a number of matters of interest to our members, including recent case law and regulatory developments, work by Section committees in anticipation of the upcoming legislative session, and CLE programs sponsored by the Business Law Section. We hope you find this newsletter, the Texas Journal of Business Law, and the information and links at our Section's website useful in your practice. In the near future, our long-awaited, updated and enhanced website will be available, and we look forward to providing our members a vastly-improved resource in that regard. I am pleased to be serving as your Chair this year and wish each of you a happy and healthy holiday season.

Kindest regards,

Beth Miller

Chair, Business Law Section, 2008-2009

SI Restructuring: Insiders May Provide a Secured Loan of Last Resort – If Careful

By: John Middleton

Haynes and Boone, LLP

The Fifth Circuit Court of Appeals recently provided guidance to Texas lawyers on the equitable subordination of insider loans of last resort to a financially troubled company. Equitable subordination generally has been understood to involve moving a creditor's valid claims behind the claims of others in order to remedy some misconduct by the creditor that harmed the debtor or other creditors. This judge-made doctrine predates the Bankruptcy Code (adopted in 1978), but its application, for the most part, has not changed. Section 510 of the Bankruptcy Code provides in relevant part that a bankruptcy court may, under principles of equitable subordination, subordinate for purposes of distribution all or part of one allowed claim to all or part of another. Courts in the Fifth Circuit and elsewhere have concluded that subordination requires three elements: (1) the claimant must have engaged in inequitable conduct; (2) the misconduct must have resulted in injury to the creditors of the debtor or conferred an unfair advantage on the

claimant; and (3) subordination must not be inconsistent with the provisions of the Bankruptcy Code.

In *Wooley v. Faulkner (In re SI Restructuring, Inc.)*, 532 F.3d 355 (5th Cir. June 20, 2008), the Fifth Circuit reversed the Bankruptcy Court for the Western District of Texas' decision to equitably subordinate the claims of former officers and directors of Schlotzsky's, Inc. ("***Schlotzsky's***"). The officers and directors (the "***Wooleys***") had extended two secured loans of last resort to Schlotzsky's in the year prior to its bankruptcy filing. After the Wooleys filed secured claims in the bankruptcy proceeding, the unsecured creditors' committee brought an adversary proceeding seeking to equitably subordinate the claims. The committee argued that the Wooleys had breached their fiduciary duties to the company by presenting the second loan as the only option outside of an immediate bankruptcy filing. It also objected to the Wooleys obtaining security not only for the loan, but also for pre-existing guarantees of the company's debt – thus essentially "releas[ing] them as guarantors on the debt." The bankruptcy court agreed with the committee and subordinated the Wooleys' claims, and the district court affirmed.

The Fifth Circuit reversed this decision, holding that the loan did not harm the company's creditors or provide the Wooleys with an unfair advantage, and thus did not meet the second element of equitable subordination. Because the proceeds from the loan had been used to pay the claims of some unsecured creditors, the class of unsecured creditors *as a whole* had not been harmed. Perhaps individual creditors had been harmed by the company's decision to pay some creditors over others, but such individualized harm cannot support subordination. The Fifth Circuit also rejected the committee's theory of harm based on a deepening insolvency theory. Such a theory essentially argues that the extension of bad debt, by prolonging a company's ultimate demise, dissipates an entity's assets to the harm of its creditors. The Fifth Circuit refused to recognize such a theory, and noted in any event that the facts of the case did not support the theory. Finally, the court overturned the lower courts' ruling that the securing of the Wooleys' guarantees provided them with an unfair advantage. No unfair advantage arose under the facts of the case, explained the court, because the guarantees were never actually triggered.

This case provides both comfort and a warning to insiders considering a secured loan of last resort to a struggling company. Such a loan should not be equitably subordinated so long as the lender does not overreach. To avoid subordination, lenders should ensure that the loan proceeds are used to pay unsecured creditors. The payment need not necessarily be distributed equally among unsecured creditors, however, which should assist in paying those vital creditors needed to stave off bankruptcy. Additionally, insiders should be extremely careful in securing existing guarantees as part of the transaction. Although this did not result in subordination of the Wooleys' claim, the opinion contains a strong indication of a different result if the guarantees had in fact been triggered. Finally, insiders should be careful to avoid placing the company under potential duress by suggesting that the loan is the only alternative to immediate bankruptcy, as this is the type of arguably inequitable conduct which called the Wooleys' loan into question. Because of the disastrous consequences of subordination, insiders should always consult with counsel and specifically consider the *SI Restructuring* opinion before providing a loan of last resort.

New Federal Rule of Evidence 502—Effect of Intentional and Inadvertent Disclosure of Protected Information

By: Christian Otteson

Deputy General Counsel - Transactions\M&A

Guaranty Financial Group Inc.

On September 19, 2008 President Bush signed a new Rule of Evidence into law: Rule 502 (Senate Bill 2450). The new rule concerns limiting subject matter and inadvertent waivers for attorney-client communications and work product. Rule 502 is applicable to the consequences in federal and state disclosure proceedings that occur at the federal level and is effective immediately to all pending and future cases.

The stated purposes of Rule 502 are to: (1) reduce the cost of time-consuming privilege review; (2) limit the consequences of both intentional and inadvertent disclosures of attorney-client communications and attorney work product; and (3) allow the parties to create their own waiver rules that are binding on themselves and third parties.

The scope of Rule 502 is as follows:

1. Subsection (a) restricts subject matter waivers to intentional disclosures where the disclosed and undisclosed information should be considered together. Thus, inadvertent waivers cannot result in subject matter waivers.
2. Subsection (b) provides that inadvertent disclosures that occur in federal proceedings will only result in a waiver of privilege or work product protection (in federal and state proceedings) if the disclosing party failed to take reasonable steps to avoid or ameliorate the disclosures.
3. Subsection (c) provides that except where a state court has already issued an order concerning the disclosure, a federal court assessing the effect (in a federal proceeding) of a disclosure that occurred at the state level must look to both the state and federal law and apply the law that provides the most protection against the waiver.
4. Subsection (d) makes federal court orders concerning waiver issues enforceable in other federal and state proceedings.
5. Subsection (e) allows the parties to create their own waiver rules if they incorporate them into a court order. Subsection (d) and (e) read together allow the parties to reach agreements binding not only on themselves, but also third parties. Such agreements supersede the default rules in subsections (a) and (b).

The New Texas Anti-Phishing Act

By: Garrett Atkinson

Haynes and Boone, LLP

Phishing is using deceptive websites and email to obtain sensitive personal information. Texas Business and Commerce Code Chapter 325, effective April 1, 2009, represents an attempt by the Texas Legislature to curb this growing problem. The Act, officially known as the Anti-Phishing Act, prohibits the fraudulent use or possession of identifying information obtained via misleading websites, domain names, or e-mails.

Chapter 325 applies to persons who act with the intent to engage in conduct involving the fraudulent possession or use of another person's identifying information. The Act defines identifying information by cross-referencing section 32.51 of the Penal Code. This definition covers all information that alone or in conjunction with other information identifies a person. This information includes, but is not limited to, social security numbers, dates of birth, government identification numbers, unique biometric data, unique electronic information, and personal identification numbers.

Section 325.004 prohibits the creation or use of a web page or domain name for fraudulent purposes. The Act prohibits:

1. the creation of a web page or domain name and the representation of such as a legitimate online business without the business owner's permission; and
2. use the fraudulent web page, link, domain name, or other web page to request, solicit, or induce another to provide identifying information for a purpose the provider believes is legitimate.

Similarly, section 325.005 prohibits phishing via e-mail. A person may not send or cause to be sent electronic mail to an address held by a Texas resident that:

1. is falsely represented as being from a legitimate business;
2. refers or links the recipient to a website represented to be associated with a legitimate online business; and
3. either directly or indirectly induces, requests, or solicits the recipient to provide identifying information for a purpose that he believes is legitimate.

The Act provides a cause of action against a person who engages in the prohibited conduct. Three entities may bring a civil action under section 325.006:

1. a person who provides internet access to the public and is damaged by the prohibited acts;

2. a trademark or website owner who is damaged by the prohibited acts; and
3. the Texas attorney general.

A plaintiff who brings an action under this statute may recover the greater of actual damages or $100,000 for each violation of the same nature. The Act defines acts of the same nature as those consisting of the same course of conduct regardless of the frequency of the conduct. If the prohibited conduct occurs often enough to constitute a pattern or practice a court may treble an award of actual damages. Additionally, a prevailing plaintiff is entitled to its reasonable attorney's fees and court costs. Injunctive relief is also available.

The Act contains a safe-harbor provision for internet service providers. Section 325.003 states that the Act does not apply to a provider of telecommunication or internet service when the provider engages in the good faith transmission, routing, or temporary storing or caching of identifying information.

The Anti-Phishing Act represents the Texas Legislature's recognition of the seriousness of fraudulent internet use. Large statutory damages and a statutory award of attorney's fees and costs to a successful plaintiff create an incentive for internet access providers and trademark holders to pursue phishers via state court litigation.

The Demise of the Single Business Enterprise Theory

By: Professor Elizabeth Miller

Baylor School of Law

The last newsletter reported on recent case law that seemed to suggest that the demise of the single business enterprise theory as a basis to impose liability might be imminent. On November 14, 2008, the Texas Supreme Court at last directly addressed the validity of the single business enterprise theory as a means to impose one corporation's liability on another and rejected the theory as inconsistent with veil piercing principles under Texas law.

Over the past couple of decades, beginning with the case of *Paramount Petroleum Corp. v. Taylor Rental Center*, 712 S.W2d 534 (Tex.App.—Houston [14th Dist.] 1986, writ ref'd n.r.e.), courts of appeals in Texas had relied upon the single business enterprise theory to impose a corporation's liability on affiliated entities or individuals who were not otherwise liable when the corporation and the affiliate had "integrated their resources for a common business purpose." The Texas Supreme Court has, on several prior occasions, refrained from endorsing or rejecting the single business enterprise theory as a means of imposing liability. Noting that the Texas Supreme Court had never endorsed the single business enterprise theory as a means of imposing liability,

the Tyler Court of Appeals recently rejected the theory. In *SSP Partners v. Gladstrong Investments (USA) Corporation*, 52 Tex. Sup. Ct. J. 95 (Nov. 14, 2008), the Texas Supreme Court pointed out that abuse and injustice are not components of the single business enterprise theory as set forth in *Paramount Petroleum*, and the court stated that there must be evidence of "inequity" or "injustice" (something beyond a subjective perception of unfairness by an individual judge or juror) to disregard the corporate structure. The court stated that there was nothing abusive or unjust about the single business enterprise factors identified in *Paramount Petroleum*, such as sharing of names, offices, accounting, employees, services, and finances. "Creation of affiliated corporations to limit liability while pursuing common goals lies firmly within the law and is commonplace," according to the Texas Supreme Court in *SSP Partners*. Citing Article 2.21 of the Texas Business Corporation Act, which employs a strict approach to veil piercing and requires actual fraud to disregard the corporate structure in certain cases, the court concluded that the single business enterprise theory is fundamentally inconsistent with the approach taken by the Legislature in Article 2.21. The court thus held that the theory as set forth in *Paramount Petroleum* will not support the imposition of one corporation's liability on another.

Business Organizations Code Committee Update

By: Daryl Robertson

Hunton & Williams LLP

The Business Organizations Code Committee is working on a draft Bill for introduction in the 2009 Texas Legislature. As has been the case in the past with many of the provisions in the Texas Business Organizations Code (the "***Code***") and its predecessor statutes, several provisions in the Bill are based on provisions in the Delaware entity statutes. The Bill would amend the Code to permit limited liability companies to establish series of membership interests to which different assets and liabilities may be allocated. The provisions are modeled after the series LLC provisions in the Delaware Limited Liability Company Act. Through appropriate provisions in the company agreement and certificate of formation, the assets of one series would be isolated from the liabilities attributable to a different series. These new provisions would allow considerable flexibility in structuring limited liability companies in Texas. Other provisions in the Bill based on the Delaware entity statutes would allow for a conversion and continuance transaction by which a non-United States entity could elect to convert to a Texas entity while maintaining its existence in its non-United States jurisdiction, and vice versa. In essence, the entity would have dual citizenship in both Texas and the non-United States jurisdiction.

On the filings front, the Bill would provide that any taxable entity (other than a nonprofit corporation) must obtain and file a tax clearance letter from the Texas Comptroller in connection with filing a certificate of termination or, for a foreign taxable entity, a certificate of withdrawal

from registration. These amendments are needed to plug gaps in coverage as a result of the expansion in the 2007 legislature of the Texas franchise tax to other entities besides corporations and limited liability companies. Another amendment would provide that a foreign filing entity is deemed to have automatically withdrawn its registration on the effective date of its conversion into a domestic filing entity. A provision would be added that states certificates of existence or registration issued by the Secretary of State may be relied upon as conclusive evidence that the domestic filing entity is in existence or that the foreign filing entity is registered and authorized to transact business in this state. Provisions in the assumed name statute in the Business & Commerce Code would also being amended to clarify that the assumed name provisions apply to foreign filing entities that register to conduct business in Texas. Other clarifications for partnerships and limited liability companies would include confirming that (1) a limited liability company can set record dates with respect to allocations and distributions; (2) the Code's limitations on distributions do not apply to payments for reasonable compensation or pursuant to bona fide retirement plans or other benefit programs; and (3) a foreign limited partnership must file an amendment to its registration to do business in Texas if it changes its general partner or the general partner changes its name. Several provisions would be added to the Code and the Business & Commerce Code to clarify that the restrictions on transfers of partnership interests and membership interests in the governing documents of a partnership or limited liability company will supersede the provisions in Chapter 9 of the Business & Commerce Code that limit the effect of transfer restrictions with respect to payment intangibles and general intangibles.

The Bill also would remove the prohibition on formation of railroad companies under the Code. The 2007 Texas Legislature made a number of amendments to the statute regulating railroad companies but unfortunately eliminated the ability to form railroad companies under that statute in the erroneous belief that a railroad company could be formed under the Code. After studying this matter and contacting several railroad industry representatives, the Committee determined that the prohibition on forming railroad companies under the Code could be removed without any material adverse effect.

Turning to the topic of management of domestic entities, the Bill would recognize that the governing documents of a domestic entity can contain emergency provisions for managing the entity if a majority of the domestic entity’s governing persons cannot readily participate in the meeting because of some catastrophic event. Other amendments would provide that ownership interests for domestic entities must not be issued in bearer form. This provision will help prevent a domestic entity from being used for illegal purposes by shielding the identity of its owners. The Bill also would clarify that a person's participation or attendance at a meeting constitutes a waiver of notice of a particular matter at the meeting that was not within the purposes described in the meeting notice unless the person objects to considering the matter when it is presented. A further clarifying provision would allow owners, members and governing persons to send consents to action by electronic transmission. This result is implicit in existing Code provisions but is made more clear by a new provision.

There are a number of other amendments in the Bill that are being made based on recommendations by the Corporation Laws Committee. Please see the report located elsewhere in this Newsletter of Rick Tulli, who chairs that Committee, for more details concerning those amendments.

The work on the Bill has been the primary focus of the Business Organizations Code Committee for the last year. As this work nears completion, the Committee will monitor developments in the 2009 Texas Legislature and look for other projects to pursue.

Proposed Corporate Amendments to the Texas Business Organizations Code

By: Rick Tulli

Gardere Wynne Sewell LLP

The Corporation Laws Committee is proposing various amendments to the Business Organizations Code for adoption in the 2009 session of the Texas Legislature. The amendments relating solely or principally to Texas corporations include provisions to:

1. Authorize a corporation to adopt procedures to deal directly with a beneficial owner of its shares, for all purposes or only for certain purposes (such as notices of shareholder meetings);
2. Permit a beneficial owner of shares for which the record owner has already asserted dissenters' rights or a demand for appraisal to file a petition for appraisal with the appropriate court;
3. Clarify the consequences of any termination of the assertion of dissenters' rights, in light of the recent court of appeals decision in *Sembera v. Petrofac Tyler, Inc.*;
4. Permit a certificate of formation to grant corporate directors different voting rights, even if the directors are not elected by separate classes or series of shares, and provide that those different voting rights will generally apply to voting on committee matters as well as board matters;
5. Clarify that board action regarding an interested-director transaction may be taken by a unanimous written consent of directors, including the consent of the interested director, in the same way that board action may be taken at a directors' meeting at which the interested director participates and votes;
6. Expressly require that a certificate of formation must authorize, and that there must always be outstanding, shares of one or more classes or series that collectively have general voting rights and the right to the residual assets of the corporation upon liquidation; and
7. Clarify that a corporation may issue shares into escrow for consideration consisting of future services or benefits to the corporation or a promissory note payable to the corporation (though the corporation must receive the required minimum statutory consideration).

For more information about these proposed amendments or the Corporation Laws Committee, please contact the Chairman of the Committee, Rick Tulli, at rtulli@gardere.com.

Law of Lawyers Committee Update

By: Christian Otteson

Deputy General Counsel - Transactions\M&A

Guaranty Financial Group Inc.

I. Update on McNulty Memorandum

In August, the United States Department of Justice revised its current policy on criminal guidelines for corporations through the Principles of Federal Prosecution of Business Organizations that provides prosecutors with five guidelines for evaluating whether a company has cooperated in an investigation, as follows:

1. Cooperation will be measured by the relevant facts and evidence disclosed by the corporation and not by the waiver of the attorney-client or work-product privileges.
2. Federal prosecutors will not demand the disclosure of "Category II" information as a condition for credit.
3. Federal prosecutors will not consider whether the corporation has advanced attorneys' fees to its employees (counter to McNulty memorandum).
4. Federal prosecutors will not consider whether the corporation has entered into a joint defense agreement.
5. Federal prosecutors will not consider whether the corporation has retained or sanctioned employees.

II. Milavetz v. United States of America (U.S. 8th Circuit), September 4, 2008

The Eighth Circuit held that bankruptcy lawyers are "debt relief agencies" under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("***BAPCPA***"), which, among other things, prohibits parties from advising clients to "incur more debt in contemplation" of a bankruptcy filing. The court then held that this prohibition is unconstitutional as applied to bankruptcy lawyers because it is not narrowly tailored. The other requirements and prohibitions of the BAPCPA still apply to bankruptcy lawyers, including certain disclosure requirements.

III. ABA Formal Opinion on Lawyer's Obligations When Outsourcing Legal and Nonlegal Support Services, August 5, 2008

The opinion is based on Model Rules of Professional Conduct. The opinion emphasizes that the outsourcing lawyer has an obligation to ensure that tasks are delegated to individuals who are competent to perform them, and then to oversee the execution of the project adequately and appropriately. The opinion also states that outsourcing lawyers should be responsible for conducting background checks of lawyers and nonlawyers to whom projects are outsourced, and conduct risk assessments of information security programs such persons have in place. It even goes so far as to argue that prior to outsourcing to foreign parties the outsourcing lawyer should investigate the system of legal education and ethics standards of the applicable countries. The opinion covers a wide variety of interesting ethical issues related to outsourcing legal services, including ethical issues associated with outsourcing to foreign countries (e.g., search and seizure standards in foreign countries; privilege waiver issues, especially in foreign countries; seeking client's informed consent prior to outsourcing; and issues related to potential unauthorized practice of law).

National Working Group on Legal Opinions Holds Seminar

By: Gail Merel

Andrews Kurth LLP

The national Working Group on Legal Opinions ("***WGLO***") held its fifth semi-annual seminar in New York City on October 28, 2008. Approximately 120 lawyers were in attendance, including representatives of various bar association groups and law firms from around the country. Gail Merel, who serves on the WGLO Steering Committee, represented the Texas Business Law Section at the seminar. Steve Tarry, current Chair of the Section's Legal Opinions

Committee, co-chaired a discussion session at the seminar on bring-down opinions; and Rick Goyne, a past Chair of the Section's Legal Opinions Committee, chaired a separate discussion session on confirmations and post-closing reports to clients and the issue of whether these later might be mischaracterized as legal opinions. Other topics discussed included: the procedural aspects of legal opinion practice, ethical considerations in opinion giving, legal opinion education, boilerplate exceptions, structured finance opinions, and current and upcoming bar reports. Copies of the seminar handbook are available for purchase by contacting the ABA Section of Business Law at (312) 988-5698 or e-mailing hajdukm@staff.abanet.org.

6th Annual Advanced Business Law Course

The Business Law Section sponsored the 6th Annual Advanced Business Law Course in Dallas on October 30-31, 2008. The Course included presentations on a variety of current topics of interest to Texas business lawyers. A description of the Course and those topics may be viewed at www.texasbarcle.com or on the Section's website, www.texasbusinesslaw.org.

The interesting and useful information and advice provided in the Course included:

1. How to complete certain of the less-than-clear items of the SEC's new electronic Form D for a private offering, and the practical ways to get reporting numbers that are necessary to file the Form D, from the presentation by Adrienne Randle Bond.
2. How to approach the transition of Texas entities existing before January 1, 2006 from the statutes under which they were formed (like the TBCA) to the Texas Business Organizations Code, and why Texas entities contemplating a winding-up and Texas non-profit corporations should seriously consider adoption of the TBOC before January 1, 2010, from the panel presentation by Beth Miller, George Coleman, Daryl Robertson, and Hank Still.
3. The recent trends regarding the scope of the accuracy of representations and warranties as a condition to closing, and the apparent discrepancy in M&A agreements in the treatment of fraud as an exception to the time limitation and the amount limitation on indemnification, from the presentation by Wilson Chu and Larry Glasgow.
4. Certain statements that a business should not include in its privacy policy, and what a business that suffers an improper or unintended release of private customer information should include in its notice of that release to its customers to help avoid the loss of customers, from the presentation by Jordan Herman.
5. Ways in which software source code is or may be protected by different kinds of intellectual property rights, and recommended provisions in software license agreements, including ways to describe licensed software and to identify the scope of the license and

the warranties that a licensee should request from the licensor, from the presentation by Irene Kosturakis.

The course is available for purchase online or on DVD. For purchase either online or on DVD, please go to www.texasbarcle.com. The Business Law Section believes that you will find the Course worthwhile.

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:

32nd Annual Conference on Securities Regulation and Business Law

- Dallas, Texas—February 12-13, 2009
- Presented by University of Texas CLE and sponsored by the Business Law Section. A discount on the registration fee will be available to Business Law Section members. The program will be held at the Belo Mansion, 2101 Ross Avenue, Dallas, Texas.

Free CLE at State Bar of Texas Annual Meeting

- 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.