MESSAGE FROM THE CHAIR

Fellow Section Members:

I'm pleased to acknowledge that various members, and the Committees of members, of our Section continue to actively work on matters and projects to benefit our Section, other Texas lawyers, and the business law in Texas. This Newsletter reflects a number of their activities, including:

- Drafting legislation to amend portions of the Texas Business Organizations Code and the Uniform Commercial Code (in the Texas Business and Commerce Code) for possible consideration by the Texas Legislature in its 2011 Session;
- Monitoring and preparing articles or written comments on recent court decisions and regulatory developments affecting Texas business entities; and
- Planning, conducting, and speaking on business-law topics at various Continuing Legal Education programs, including those sponsored by our Section.

If you're interested in participating in any of these, or any other, activities of our Section, you're certainly welcome to do so. Our website, www.texasbusinesslaw.org, contains information about the Section's Committees and the persons you can contact about them. If you would like to participate, you should also feel free to contact me.

I hope that this Newsletter provides information of interest to you and of value to your practice.

I wish each of you a happy holiday season and personal and professional success in the coming year!

Rick Tulli
Chair of the Business Law Section, 2010-11

A SUMMARY OF THE DODD – FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT (FOR NON-FINANCIAL INSTITUTION LAWYERS)

By: Carol B. Matticks
[Firm Name]

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "***Dodd-Frank Act***") is a piece of federal legislation that cuts a wide swath, including reorganizing the regulatory framework for financial institutions, creating a means to put large financial institutions through a resolution, winding down and dissolution process and regulating the sale of "swaps" and other derivative securities for the first time. The Dodd-Frank Act also provides an opening for the federal government to become involved with future regulation of insurance businesses – an area previously reserved exclusively to the states. While those issues will affect many business borrowers and those who invest in the nation's securities markets, lawyers who

represent non-financial businesses and practice transactional law should be aware of the other things the Dodd-Frank Act does. Following is a quick list:

I Regulation of Private Investment Vehicles and Their Sponsors or Advisers.

Although there have always been private investment companies or "funds" that were not required to adhere to mutual fund regulation and which were advised or sponsored by persons who were not required to register as advisers, the 1990's saw the rise of a particular subset of these funds – "hedge funds". Hedge funds generally own publicly traded securities and trade their holdings on the public market. As the 1990's and 2000's progressed, hedge funds began to engage in riskier investment strategies, buying more exotic and a larger quantity of derivative securities to provide their owners with much greater returns than the market overall. Regulators were worried about hedge funds because they had no detailed information about the overall size of the sector or common practices (because no fund or adviser was required to register) and only learned about them when there was a spectacular failure. Two hedge funds run by Bear Stearns went under in March 2008 and are generally thought of as the first warning signs of the 2008 financial crises. In response, the Dodd-Frank Act:

Made revisions to Section 203(b) of the Investment Advisers Act to remove the exemption from adviser registration for advisers of "private funds"

- "Private funds" are defined as those funds that would meet the criteria for exemption under the Investment Company Act Section 3(c)(1) (those that have 100 or fewer beneficial owners), or Section 3(c)(7) (those that are owned exclusively by "qualified purchasers")
- "Qualified purchasers" are defined as: (i) natural persons with $5 million or more in investments; (ii) companies owned by related natural persons with $5 million or more in investments; or (iii) entities with at least $25 million in investments.
- The Securities and Exchange Commission is directed to propose and make rules that would exempt venture capital advisers, offices managing family wealth, and advisers that only advise private funds and have assets under management in the U.S. of less than $150 million. Those exempted in this last category would still have requirements to report activities to the securities regulators.

In addition, the Dodd-Frank Act re-apportioned the responsibility between the states and the federal agencies for regulating advisers. Previously, all advisers with $25 million or less under management were required to register with the states in which the adviser resided and in which its clients resided. Section 203A of the Investment Advisers Act will now require that all advisers with $100 million or less under management be registered by the states in which they do business. However, if these "mid-sized' advisers would have to register in 15 or more states, they can choose to register with the SEC. All advisers with more than $100 million under management will be required to register with the SEC.

II Regulation that Affects Companies Seeking to Raise Private Equity Capital, Receive a Minority Investment or Sell Outright in a Private Transaction.

It should be noted that all of the private funds mentioned above will have to conduct a securities offering exempt from state and federal registration requirements in order to bring in beneficial owners or qualified purchasers. However, the Dodd-Frank Act made revisions to elements of commonly used exemptions from requirements to register offerings that will affect all companies seeking to raise private equity capital, receive a private minority investment or sell all of their securities issued and outstanding in a private transaction.

- The definition of the term "Accredited Investor" as used in Regulation D ("***Reg D***") and other exemptions from registration of offerings now provides that the $1 million net assets test cannot include the value of the natural person accredited investor's primary residence.
- The Dodd-Frank Act also directs the SEC to review and consider changes to the annual income and net asset tests to qualify as a natural person Accredited Investor every four years, beginning four years from the date of the legislation.

The most widely used federal exemption from the requirement to register a securities offering is Rule 506 of Reg D. If it sells securities only to Accredited Investors under Rule 506, an issuer can avoid specific information disclosure requirements (but not the overall requirement that it provide investors with all the information necessary to make an informed investment decision). An issuer can also avoid state regulation other than notice filings and fees if it offers securities under Rule 506. However, the Dodd-Frank Act directs the SEC to engage in rulemaking that would limit the kinds of issuers who can use Rule 506 to those who are not bad actors or associated with bad actors

- as defined in 17 CFR 230.262 and
- subject to order by state regulators within the last ten years <u>or</u>
- convicted of a felony or misdemeanor involving the sale of securities.

III A General Tightening of Securities Laws and their Enforcement

The Dodd Frank Act provided an opportunity for regulators to strengthen their hand in any investigation and subsequent litigation that regulators bring against people or companies in the private sector. For instance:

- A subpoena to compel testimony or production of documents issued by a court on motion of the SEC in any jurisdiction can be served in any other jurisdiction in the U.S.
- Information that is obtained from registered persons in the course of an investigation would formerly be required to be made public. Now, the SEC can maintain the information received as confidential if it is "for use in furtherance of the purposes of this title, including surveillance, risk assessments, or other regulatory and oversight activities"
- The SEC will not be deemed to have waived a privilege by transferring information to other federal or state agencies, SRO's or law enforcement agencies nor will the privilege be waived by others who transfer information to the SEC.
- The standard for aiding and abetting a securities law violation has been changed to explicitly include recklessness: "any person that knowingly or recklessly provides substantial assistance to another person in violation of a [statute] rule or regulation……

shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided."

COMMERCIAL CODE COMMITTEE UPDATE

By: James H. Leeland
Chair
Commercial Code Committee Business Law Section, State Bar of Texas

The Commercial Code Committee of the Business Law Section has been working on proposed amendments to Articles 2 and 9 of the Uniform Commercial Code (Tex. Bus. & Com. Code Art. 2 and Art. 9) for the upcoming Texas Legislative Session.

The proposed Article 9 Amendments were recently approved by the National Conference of Commissioners on Uniform State Laws. The Article 9 Subcommittee is reviewing the changes and expects to retain Texas's current non-uniform § 9.518 (Vernon's 2007). It also proposes to adopt a non-uniform change to § 9-503 to meet Texas's unique requirements regarding debtor names. Many of the amendments are designed to improve § 9-502, Contents of Financing Statement, and § 9-503, Name of Debtor and Secured Party, to provide more clarity and certainty in identifying the name of the debtor on financing statements. Jackie Akins, the current chair of the Article 9 Subcommittee, is working with members of her Subcommittee toward the completion of a Bill Analysis and proposed Bill for the next Legislative Session.

The Article 2 Subcommittee, co-chaired by Prof. Roy Anderson of SMU Law School and Jim Leeland, has completed a Bill Analysis and proposed Bill, intended to clarify and provide minor updating on approximately ten sections of UCC Article 2 on the sale of goods. For example, under Section 2.103, Definitions and Index of definitions, the proposed amendments include several new definitions, most of which are designed to give effect to electronic contracting, which did not exist when Article 2 was originally passed over forty years ago.

Section 2.108, Transactions Subject to Other Law, would be a new section modeled on current Section 2A.104, Leasing. It is intended to resolve persistent problems concerning conflicts between Article 2 and State Certificate of title acts. Under Texas case law, a conflict exists between the rights of a holder of a certificate of title under the Certificate of Title Act and those of a buyer in the ordinary course of business under 2.403(b) TBCA. *See Associates Discount Corp. v. Rattan Chevrolet, Inc.*, 462 S.W.2d 546 (Tex. 1970) (conflicts between title act and UCC are governed by the UCC) vs. *Gallas v. Car Biz, Inc.*, 914 S.W.2d 592 (Tex. App. -- Dallas 1995) (title act governs). The proposed provision, by contrast, should clear up this conflict by giving primacy to a certificate of title act, "[e]xcept with respect to the rights of a buyer in the ordinary course of business under Section 2.403(b), which arise before a certificate of title covering the goods is effective in the name of any other buyer."

The Subcommittee also proposes to amend Section 2.201 on the Statute of Frauds for the sale of goods. Current 2.201(a) provides that contracts for the sale of goods for the price of $500 or more must be in writing. Since this price limitation was set more than 40 years ago, the amendment proposes to increase the amount from $500 to $5,000 (a reasonable amount in view of inflation). The amendment would also change the word "writing" to "record" to harmonize

the statute with the present definition of “Record” under 1.201(31) Tex. Bus. & Com. Code, which recognizes contracting by electronic medium, as enacted by the Texas Legislature in 2005.

Section 2.325, Letter of Credit, would be modified to conform to Revised Chapter 5 on Letters of Credit, which was substantially revised by the Legislature in 1999.

A proposed amendment of Section 2.508, dealing with a seller's right to cure, would give the seller a limited right to cure after a buyer's revocation of acceptance, but only in the context of non-consumer transactions. The section is rewritten to allow the seller in a commercial transaction the right to cure because of a latent defect in the goods, where the seller has not had a prior opportunity to cure the defect before the buyer can revoke acceptance of the goods. This is the only proposed substantive change of note for this section. Under the present holding in *Gappelberg* v. *Landrum,* 666 S.W.2d 88, 91 (Tex. 1984), the seller does not have such a right after the buyer has properly revoked acceptance of the goods, even where the seller had no prior opportunity to cure a latent defect in the goods. The proposed amendment will offer some limited relief from this rule to sellers in commercial transactions. But it will not permit the seller a second bite at the apple, where the seller had the opportunity before to cure the defect but either failed or refused to cure.

Proposed amendments to Sections 2.706, 2.708, and 2.709 have been made to allow for a seller's recovery of consequential damages, as provided for under proposed amended Section 2.710, but only in non-consumer transactions. Although sellers rarely suffer compensable consequential damages, the denial of their recovery to sellers in transactions "between merchants" has been criticized as inconsistent with Section 1.305, which provides that remedies under the Code should be administered so as to compensate for the full lost expectation of the aggrieved party. Buyers, moreover, already have the right to recover consequential damages under Article 2.

These amendments will clarify and update Texas law in needed areas, with little substantive change. The proposed Bill Analysis and Bill amendments may be viewed on the Business Law Section website.

RECENT CASES ADDRESSING THE EFFECT OF A CONVERSION

By: Professor Elizabeth Miller
Baylor School of Law

Grohman v. Kahlig, 318 S.W.3d 882 (Tex. 2010) (per curiam).

The Texas Supreme Court disagreed with the conclusion of the court of appeals in this case and held that the conversion of two corporations into limited partnerships did not violate the terms of a security agreement covering shares of stock in the corporations. As part of a divorce settlement in 2001, Kahlig executed a promissory note payable to Grohman secured by 70% of Kahlig’s stock in two corporations. In 2003, the corporations were converted to limited

partnerships to save franchise taxes. Pursuant to the plan of reorganization, as described by the Court, Kahlig formed a holding company for each of the two corporations and contributed his stock in each corporation to the corresponding holding company. Kahlig then converted the corporations to limited partnerships, and each holding company received limited partnership units in exchange for the stock in the converted corporations, which was canceled once it was replaced with the limited partnership units. (In 2007, when the limited partnership form no longer provided a franchise tax advantage, the entities were converted back to corporations.) Grohman sued Kahlig in 2005 and asserted that the conversions resulted in a breach of the terms of the security agreement under which Kahlig agreed not to "sell, transfer, lease or otherwise dispose of the Collateral or any interest therein" without Grohman's consent and further agreed not to "allow the Collateral to become wasted or destroyed." The court of appeals agreed with Grohman and held that Kahlig breached the security agreement because he "disposed of" the Collateral in violation of the security agreement. According to the court of appeals, Kahlig destroyed the shares of stock when the shares were converted to limited partnership units because the shares were canceled and ceased to exist. The Supreme Court, however, focused on the definition of "Collateral" in the security agreement, which encompassed "all replacements, additions, and substitutions," and concluded that the conversion did not destroy the Collateral. The Court pointed out that the shares of stock that were canceled in the conversion were first replaced with limited partnership units that represented the same interest in the businesses. Kahlig remained the owner of his interest in the businesses, and the change in form of the Collateral did not destroy it according to the Supreme Court. Grohman did not dispute that the value of the Collateral actually increased (due to the more beneficial franchise tax treatment). Grohman also argued that Kahlig "transferred" the Collateral in the conversion because the plan of reorganization involved movement of interest in the companies between Kahlig and the holding companies. The Court stated that Kahlig retained ownership of his entire interest in the companies throughout the conversion despite the technical movement of business interests between him and his holding companies. Thus, the Collateral was not transferred, and Grohman's security interest was not impaired. The Court noted that the security agreement lacked any specific mention of the consequences of a business entity conversion, and the Court stated that the most reasonable interpretation of the agreement, read as a whole, was that it did not prohibit Kahlig from converting the business entities and that Kahlig did not breach the agreement at any point in the conversion. [Practice Note: The change of the form of collateral from stock to a partnership interest or a membership interest in an LLC pursuant to a conversion could significantly disadvantage the secured creditor inasmuch as foreclosure on a partnership interest or membership interest would only confer the rights of an assignee on the purchaser of the interest, i.e., a secured party or other party who purchases the interest in foreclosure would not acquire the rights of a partner or member to vote or otherwise participate in the management of the entity, whereas foreclosure on the stock would entitle the purchaser of the stock to vote the stock. A lender/secured party should thus consider including language that specifically prohibits a change in the form of the collateral as a result of a conversion or otherwise.]

VRV Dev., L.P. v. Mid-Continent Cas. Co., Civil Action No. 3:09-CV-1382, 2010 WL 375499 (N.D. Tex. Feb. 3, 2010).

The district court in this case held that an insurance policy covering a corporation did not cover the entity after it converted into a limited partnership. The corporation purchased a liability insurance policy in 2004 that was renewed in 2005 and expired in 2006. The corporation converted into a limited partnership on January 1, 2005. The insurer was never informed of the conversion of the corporation into a limited partnership, nor was coverage for the limited partnership ever requested. The limited partnership, general partner, and sole limited partner (the "plaintiffs") demanded a defense and indemnification under the policy with respect to claims asserted against them, and the insurer denied the plaintiffs' demands. The plaintiffs filed this suit against the insurer, and both sides sought summary judgment. The insurer argued as a threshold matter that none of the plaintiffs were insured under the policy because none of them were expressly named as a "Named Insured" in the policy declaration. The only "Named Insured" was the corporation. The court agreed with the plaintiffs, however, that an exception to the "eight corners rule" of insurance contract construction allowed consideration of extrinsic evidence to determine whether the plaintiffs were insured under the policy. The extrinsic evidence showed that the corporation was converted to a limited partnership effective January 1, 2005. The plaintiffs argued that the partnership is the "legal equal" of the corporation under Texas law. The plaintiffs cited the conversion provisions of the Texas Business Corporation Act regarding the effect of a conversion and relied upon a case in which a guarantor could not escape his guarantee obligation to a business entity solely by virtue of the entity's change in name or organizational form. The court distinguished that case, however, and stated that the insurer had not contracted to pay a simple debt, but to bear a risk that it evaluated and voluntarily accepted. The court concluded that allowing the plaintiffs to substitute a new party to an insurance contract, without the insurer's knowledge or approval and without giving the insurer the opportunity to evaluate the entity or person it is purportedly insuring, materially rewrites the insurance contract in a way that appears to contravene existing authority. The court also relied upon a provision in the policy that stated that "'no person or organization is an insured with respect to the conduct of any current or past partnership, joint venture or limited liability company that is not shown as a named insured in the Declarations.'" Because the corporation was the only named insured, it never notified the insurer or requested coverage for the converted entity, and the insurer never had the opportunity to evaluate the general partner or any other change in the business structure, the plaintiffs were not insured under the policy.