BUSINESS LITIGATION – UPDATE: A SURVEY OF RECENT IMPORTANT DEVELOPMENTS

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BUSINESS LITIGATION- UPDATE: A SURVEY OF RECENT IMPORTANT DEVLEOPMENTS

I. Introduction

Both the legal and business worlds change rapidly. Accordingly, it is not surprising that business law can be a rather fluid and ever-changing area. Changes often are borne in litigation, an aspect of the law that some transactional attorneys may prefer to avoid. It is a mistake, however, for transactional attorneys to completely ignore litigation developments, as these developments can often be critical. Regardless of whether the change to the law is small or large, it is very often the case that the change should materially affect the advice and work of transactional attorneys.

Unfortunately, it is simply not possible to catalog all of the recent developments that may interest Texas business lawyers. The practice of business law involves many different legal areas, all of which have various material recent developments. Moreover, advising clients in business law matters often involves multiple jurisdictions. For example, some attorneys may have clients whose geographic footprint may not only include multiple states, but also multiple countries. In short, a comprehensive litigation update is well beyond the scope of this paper.

This paper provides a general overview of certain recent litigation developments. The matters discussed below were selected to cover multiple areas in Texas as well as a few recent legal developments in Delaware. In addition to strictly litigation matters, the paper also addresses certain SEC whistleblower provisions that will inevitably lead to additional regulatory and litigation issues for clients. The hope is that the paper will not only provide some targeted updates on matters of interest, but will also underscore the need for transactional lawyers to stay abreast of litigation developments in their area.

II. The Existence of a Partnership

In *Ingram v. Deere*,[1] the Texas Supreme Court faced the question of how to weigh the factual evidence in determining the existence of a de facto partnership under the Texas Revised Partnership Act (TRPA). In that case, Ingram, a licensed psychologist, and Deere, a board certified psychiatrist, entered into an oral agreement in 1997. The agreement provided that Deere would serve as the medical director for a multidisciplinary pain clinic. Deere claimed that the parties agreed to split revenues as follows: one-third to Deere, one-third to Ingram, and one-third to pay the clinic's expenses. He also asserted that Ingram had described their work as "a joint venture, or [they] were partners, or [they] were doing this together." In contrast, Ingram contended that they agreed only that Deere would receive one-third of the clinic's revenues, and there was no agreement as to the other two-thirds of the revenues. Deere never contributed money to the clinic, he did not participate in the hiring of any employees, he did not know any of the clinic staff's names, he never purchased any of the clinic's equipment, his name was not on the clinic's bank account, and his name was not on the lease agreement for the clinic space. About one year into the relationship, Ingram prepared a written agreement, entitled "Physician Contractual Employment Agreement," which stated that Ingram was the sole owner of the clinic. Deere refused to sign the document, asserted that it did not reflect their agreement, and immediately ceased working at the clinic.

Deere later sued Ingram, and a jury found that they had entered into a partnership agreement. The jury also found that Ingram breached both the partnership agreement and his fiduciary duty to Deere. The trial court ultimately granted two successive judgments n.o.v. The first eliminated the breach of fiduciary finding and reduced the damages, and the second eliminated the remaining causes of action and rendered a take-nothing judgment in Ingram's favor. Deere appealed, and the appellate court reversed and reinstated the trial court's original judgment. Ingram then appealed to the Supreme Court.

To answer the question of whether Ingram and Deere formed a partnership, the Supreme Court reviewed both common law and Texas statutory law. The common law recognized that the parties' intent is a "prime element in determining whether or not a

[1] 288 S.W.3d 886 (Tex. 2009).

partnership or joint venture exists."[2] Under the common law, profit sharing was the most important element to determine whether a partnership existed.[3] Ultimately, the concepts of the parties' intent and profit sharing were incorporated into a five-factor test for partnership formation: (1) intent to form a partnership; (2) a community of interest in the venture; (3) an agreement to share profits; (4) an agreement to share losses; and (5) a mutual right of control or management of the enterprise.[4] The common law required proof of all five factors to establish a partnership.[5]

Texas later adopted the Texas Uniform Partnership Act (TUPA) in 1961. Effective in 1994, TRPA replaced TUPA. TUPA had promulgated some of the common law concepts, and TRPA carried some of those elements forward. Because Ingram and Deere allegedly formed their partnership in 1997, it was governed by TRPA.

TRPA provides that "an association of two or more persons to carry on a business for profit as owners creates a partnership."[6] TRPA articulates five factors, similar to the common law factors, that indicate the creation of a partnership. They are:

> (1) receipt or right to receive a share of profits of the business;
> (2) expression of an intent to be partners in the business;
> (3) participation or right to participate in control of the business;
> (4) sharing or agreeing to share:
> (A) losses of the business; or
> (B) liability for claims by third parties against the business; and
> (5) contributing or agreeing to contribute money or property to the business.[7]

Unlike the common law, TRPA does not require proof of all five factors, but it instead "contemplates a less formalistic and more practical approach to recognizing the formation of a partnership."[8] The question for the Court was how many of the TRPA factors are required to form a partnership. The Court concluded that "whether a partnership exists should be decided considering all the evidence bearing on the TRPA partnership factors."[9] The Court looked at the evidence of each of the five factors. For the profit sharing element, the Court held that a share of profits paid as "wages or other compensation" is not indicative of a partnership interest in a business, and Deere received payments as wages, not profits.[10] Moreover, the Court noted that Deere was paid "revenues," not "profits."

Regarding the expression of intent to be partners, the Court noted that review should include "the putative partners' speech, writings, and conduct."[11] The Court also contrasted from the common law, noting that while under common law, evidence probative on other factors is considered evidence of "intent," under TRPA, the "expression of intent" factor is an inquiry separate and apart from the other factors, so courts should only consider evidence "not specifically probative of the other factors. In other words, evidence of profit or loss sharing, control, or contribution of money or property should not be considered evidence of an expression of intent to be partners."[12] The Court concluded that all of Deere's evidence of intent was predicated upon evidence of other TRPA factors, so it could not be considered for the "intent" element.[13] Additionally, Deere's proof did not include any evidence of Ingram's intent to be partners. Instead, evidence that Ingram expressed an intent to be partners was limited to Deere's testimony that Ingram vaguely represented that "this was a joint venture, or that [they] were partners, or [they] were doing this together."[14] After Deere joined the clinic, the clinic's name did not change, Deere never signed a lease agreement for the clinic, he was not named on the clinic's bank account, and he never filed taxes stating that he was a co-owner of the clinic. Deere paid his own medical malpractice insurance, which he acknowledged was his common practice when

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[2] *Id*. at 894 (quoting Coastal Plains Dev. Corp. v. Micrea, Inc., 572 S.W.2d 285, 287 (Tex. 1978)).
[3] *Id*.
[4] *Id*.
[5] *Id*. at 895.
[6] TEX. REV. CIV. STAT. art. 6132b-2.02(a).
[7] TRPA art. 6132b-2.03(a).
[8] *Ingram*, 288 S.W.3d at 895.
[9] *Id*.
[10] *Id*. at 898–99.
[11] *Id*. at 899.
[12] *Id*.
[13] *Id*. at 900.
[14] *Id*. at 901.

he did contract work.

Regarding the element of "control," the Court equated control with "the right to make executive decisions."[15] Sporadically receiving information about the business, as Deere did, is not evidence of control. Ultimately, the Court concluded that Deere had no evidence of this factor, because the facts established only that Ingram discussed the business with Deere, just as owners would commonly discuss their business with consultants.

The fourth factor is the sharing of losses and liability for third party claims. The Court noted that under TRPA, "an agreement to share losses is not necessary to create a partnership."[16] The absence of that agreement was not fatal to Deere's claim, while evidence of that agreement could support Deere's argument for establishing a partnership. While Deere testified that one-third of the revenues would cover the partnership's expenses, he stated that there was no discussion of how they would cover any expenses that exceeded one-third of the revenues. Those expenses would constitute an operating loss, and the Court concluded that the parties never discussed losses, but instead they discussed only expenses. Without more, there is no evidence to support the assertion that Ingram and Deere agreed to share losses.

Finally, Deere does not argue that there was any agreement that he contributed either money or property to the enterprise. Instead, he asserted that he contributed his reputation to the alleged partnership. The Court concluded that TRPA would allow the contribution of an individual's reputation, but doing so does not automatically create a de facto partnership. Instead, the Court stated that "at a minimum, the putative partner would have to prove that any such value can be distinguished from services rendered or property given as an employee."[17] First, the Court determined that no evidence suggested that Deere's reputation was of any value to the clinic. Second, there was no evidence that Deere added value as a partner, rather than as an employee.

The Court concluded that "whether a partnership exists must be determined by an examination of the totality of the circumstances. Evidence of none of the factors under the Texas Revised Partnership Act will preclude the recognition of a partnership, and even conclusive evidence of only one factor will also normally be insufficient to establish the existence of a partnership under TRPA. However, conclusive evidence of all five factors establishes a partnership as a matter of law." The Court concluded that Deere had not provided legally sufficient evidence of any of the five TRPA factors, so the Court reversed the appellate judgment and reinstated the trial court's take-nothing judgment.

The Court left a few open issues. First, the Court concluded that there was no evidence of any of the five factors, so it did not engage in weighing evidence in an instance where only one of the five factors was present. Second, the Court's discussion emphasized the importance of having evidence of both parties' expression of intent to form a partnership. While Deere testified that he and Ingram had expressed an intent to be partners, he offered no evidence from Ingram had confirmed that intent. Finally, while the Court agreed that a person can contribute their reputation to a partnership, the Court appeared to strictly apply that evidence.

III. <u>Arbitration – Contractual Scope of Review</u>

Users have articulated three primary complaints about arbitration: a concern that arbitrators "split the baby," a failure to recognize the expected savings associated with arbitration, and a lack of appellate remedies. One solution that parties have applied to overcome the final barrier was to contract to expand the scope of appellate review available in district courts.

For years, federal appellate courts were split regarding whether parties could contract to expand district court review of arbitration awards. The Ninth and Tenth Circuits have held that parties may not contract for expanded judicial review.[18] The First, Third, Fifth, and Sixth Circuits have reached the opposite

[15] *Id.* (citing *Brown v. Cole*, 291 S.W.2d 704, 710 (1956)).
[16] *Id.* at 902.
[17] *Id.* at 903.

[18] *See Kyocera Corp. v. Prudential Bache Trade Servs., Inc.*, 341 F. 3d 987, 1000 (9th Cir. 2003); *Bowen v. Amoco Pipeline Co.*, 254 F. 3d 925, 936 (10th Cir. 2001).

conclusion.[19] The United States Supreme Court ultimately resolved this question in *Hall Street Associates, L.L.C. v. Mattel, Inc.,* 552 U.S. 576 (2008). In *Hall Street*, the Court concluded that Sections 10 and 11 of the Federal Arbitration Act provided the FAA's "exclusive grounds for expedited vacatur and modification." With that holding, the Supreme Court foreclosed the possibility of expanding the scope of judicial review under the Federal Arbitration Act. The Court did note, however, that expanded review may remain available under common law and state statutory arbitration schemes.

The Texas Supreme Court has concluded that the Texas Arbitration Act provides one of the state statutory schemes that allows parties to contract for expanded judicial review. In *Nafta Traders, Inc. v. Quinn*, 339 S.W.3d 84 (Tex. 2011), the Court faced an arbitration in which the parties did not define whether it was governed by the FAA, the TAA, or common law. The arbitration provision, which appeared in an employee handbook, did include a provision that restricted the arbitrator's authority as follows: "The arbitrator does not have authority (i) to render a decision which contains a reversible error of state or federal law, or (ii) to apply a cause of action or remedy not expressly provided for under existing state or federal law."[20] Nafta Traders contended that those limits on the arbitrator's authority effectively constituted an agreement to expand the scope of judicial review otherwise available under the TAA. Facing that expanded scope of review, the Court held that "the [Texas Arbitration Act] presents no impediment to an agreement that limits the authority of an arbitrator in deciding a matter and thus allows for judicial review of an arbitration award for reversible error."

The Court reached a second, and often overlooked, ruling. The Court had noted that the parties did not specify what law governed their agreement, and the FAA potentially applied. In that setting, following *Hall Street*, the Court could have concluded that the Federal Act preempted the state act and foreclosed expansion of judicial review. Had it done so, the Court would have significantly limited the *Hall Street* Court's view that state statutory schemes could provide expanded review. In addressing the question, the Texas Supreme Court concluded that "the FAA does not preempt enforcement of an agreement for expanded judicial review of an arbitration award enforceable under the TAA."[21]

IV. Arbitration – Arbitrator Disclosure

Another concern damping the use of arbitration is the fear that party-appointed arbitrators are biased in favor of the appointing party. While there are mechanisms to avoid that potential bias, such as the American Arbitration Association's ranking system, courts share the concern regarding arbitrator partiality. Two recent cases illustrate the point that arbitrators must not only be free of bias, but they must also make complete disclosures so that the parties to the arbitration can assess that potential bias.

In *Karlseng v. Cooke*,[22] Fish & Richardson, P.C. represented one of the parties to the arbitration. The arbitrator was a former federal magistrate judge, and he disclosed that he had previously served as an arbitrator in a case in which one of the Fish & Richardson attorneys had served as counsel.

Four days after the disclosures were made, another Fish & Richardson attorney appeared as lead counsel. No new disclosures were made by the arbitrator, who later awarded $22 million in favor of Fish & Richardson's client. The award included $6 million in attorneys' fees.

The court of appeals noted that the arbitrator had not disclosed any of these facts regarding his relationship with the lead counsel in the case:

- The attorney had clerked for a federal judge in Sherman, Texas, where the arbitrator was the only magistrate judge;
- The attorney and his ex-wife had socialized with the arbitrator and his wife;

[19] *See Puerto Rico Tel. Co. v. U. S. Phone Mfg. Corp.*, 427 F. 3d 21, 31 (1st Cir. 2005); *Jacada (Europe), Ltd. v. Int'l Mktg. Strategies, Inc.*, 401 F. 3d 701, 710 (6th Cir. 2005); *Roadway Package Sys., Inc. v. Kayser*, 257 F. 3d 287, 288 (3rd Cir. 2001); *Gateway Techs., Inc. v. MCI Telecomms. Corp.*, 64 F. 3d 993, 997 (5th Cir. 1995).

[20] 339 S.W.3d at 88.

[21] 339 S.W.3d at 101.

[22] 346 S.W.3d 85 (Tex. App.—Dallas 2011, no pet. h.).

- When the arbitrator retired from the bench, the attorney hosted a dinner celebrating the retirement;
- The arbitrator, the attorney, and their wives attended a country club dinner, paid for by the arbitrator, and they met beforehand at the arbitrator's home;
- The attorney offered to treat the arbitrator to an April 2006 Mavericks game, and they exchanged several emails, addressed on a first-name basis, to schedule the game. Ultimately, they cancelled their plans to attend the game, because the arbitrator was then presiding over an arbitration in which the attorney was involved;
- The arbitrator provided recommendations to the attorneys for restaurants and wineries to visit on an upcoming visit to California;
- The arbitrator served as arbitrator in an arbitration involving Fish & Richardson seeking unpaid fees from a former client;
- The arbitrator hosted the attorney and his family for a meal at the Tower Club;
- In December 2006, the arbitrator, the attorney, and their wives attended a Mavericks game ($1200 cost) and dinner ($428) at the arbitrator's expense;
- The attorney sent the arbitrator a basket of wine at Christmas.

Two months later, the arbitrator was selected to preside over the *Cooke* case. When the hearing commenced, the undisputed evidence was that the arbitrator and attorney acted as complete strangers, going so far as to introduce themselves to each other in front of the other attorneys at the first in-person hearing. While the case was pending, the attorney suspended his Christmas gifts to the arbitrator, but they resumed after the award was rendered. Moreover, the arbitrator invited the attorney to dinner at the Mansion shortly after the proceeding was over.

The trial court confirmed the award over an objection. In reviewing that judgment, the appellate court focused on whether the award should be set aside based upon the arbitrator's evident partiality. It noted that while the courts have primarily addressed issues related to business and financial transactions, they are not unaware of other important relationships that certainly impact an arbitrator's judgment, such as personal and social relationships. Information about the existence and extent of each of these relationships is essential to the fair and impartial nature of the arbitration process, particularly in view of the substantial discretion invested in an arbitrator to decide both law and facts and the limited appellate review of these decisions. The court held that bias is not limited solely to pecuniary relationships, but can also include a personal/social relationship, because "the parties should have access to all information that might reasonably affect the potential arbitrator's impartiality."[23] Ultimately, the court concluded that the parties, not the courts, are better evaluators of bias, which is why arbitrators must disclose information before or during the arbitration itself, when the parties have an opportunity to evaluate the information. Ultimately, the court reversed the judgment and remanded for further proceedings.

A second case also involved a lack of disclosure. In *Amoco D.T. Co. v. Occidental Petroleum Corp.*,[24] each of two parties appointed an arbitrator, and those arbitrators appointed a third arbitrator. After the arbitrators were appointed, one of the arbitrators joined a new firm. That new firm represented one of the parties in unrelated litigation. The arbitrator failed to disclose his new firm's representation of that party. The panel rendered a 2-1 decision in favor of that arbitrator's firm's client. The trial court later vacated the award, and an appeal followed.

The appellate court again applied the "evident partiality" test from *TUCO*. In the process, the court specifically rejected the argument that a party would waive an objection to evident impartiality by failing to investigate the arbitrator's background. The court also rejected the argument that because the

[23] *Id.* at 98 (quoting *Burlington N. R.R. Co. v. TUCO, Inc*, 960 S.W.2d 633, 637 (Tex. 1997)).
[24] 343 S.W.3d 837 (Tex. App.—Houston [14th Dist.] 2011, pet. filed).

arbitrator's firm was also opposite the party in yet another case meant that the alleged bias "balanced out" and need not be disclosed. Ultimately the court concluded that "the fact that a reasonable person could conclude the circumstances *might* have affected [the arbitrator's] impartiality triggered his duty to disclose. . . . Thus, the fact that [he] failed to disclose non-trivial information was sufficient to establish evident partiality."[25] The court affirmed the trial court's vacatur.

With these cases, the appellate courts have attempted to reinforce the dignity of arbitration by affirming an arbitrator's ongoing duty to disclose. For parties involved in arbitration, they should avoid arbitrators who have an obvious bias, as well as counsel who suggest that they have an "in" with an arbitrator. They should insist on full disclosure of their arbitrator's possible conflicts, under the "better safe than sorry" approach.

V. The Texas Supreme Court Limits Effect of Merger Clauses on Fraud Claims

Over the last several years, the Texas Supreme Court has issued a series of decisions addressing the requirements for a contractual disclaimer of reliance on representations between the contracting parties. A brief review of these cases is helpful before discussing the Court's recent opinion in *Italian Cowboy Partners, Ltd. v. Prudential Insurance Co. of America, et al.*

A. *Schlumberger*

In 1997, the Court issued its opinion in *Schlumberger Technology Co. v. Swanson*, which addressed the enforceability of such contractual provisions. The facts of *Schlumberger* revolve around a diamond mine off the shore of South Africa. In that case, John and George Swanson (the "Swansons") were brothers whose family had been in the mining industry for decades.[26] The Swansons entered into an agreement with SEDCO, Inc. in which the Swansons obtained the right to purchase five percent of shares to mine diamonds.[27] After entering this deal, Schlumberger acquired SEDCO and negotiated a joint venture agreement to mine the diamonds with other companies.[28]

After Schlumberger purchased SEDCO, Schlumberger represented that the diamond mine project was not feasible and a dispute arose between the Swansons and Schlumberger over continuation of the project. Eventually, the Swansons elected not to sue and agreed to sell their interest to Schlumberger. As a condition of the sale, the Swansons "relinquished all rights, claims, and interests in the offshore diamond project . . . and released all causes of action against Schlumberger, known or unknown."[29] Importantly, in the release, the Swansons "specifically agreed that they were not relying on any statement or representation . . . and that they had been represented by counsel who had explained the entire contents and legal consequences of the release."[30]

Unfortunately for the Swansons, after selling their interest, Schlumberger sold its interest in the joint venture for an amount far in excess of what it told the Swansons it could obtain.[31] In response to the sale, the Swansons sued Schlumberger for "fraudulently inducing them to sell their interest at an undervalued price" by making misrepresentations as to the technical and commercial feasibility of the project.[32] In short, the Swansons were arguing that the reliance disclaimer in their contract with Schlumberger should not be binding.

Schlumberger stands for the proposition "that a release that clearly expresses the parties' intent to waive fraudulent inducement claims, or one that disclaims reliance on representations about specific matters in dispute, can preclude a claim of fraudulent inducement."[33] This ruling is a result of Texas law favoring and encouraging "voluntary settlements and orderly dispute resolution."[34] However, under *Schlumberger*, such clauses "will not always bar a fraudulent inducement claim."[35] In fact, in

[25] *Id*. at 850.
[26] *Id.* at 172.
[27] *Id.* at 173.
[28] *Id.*
[29] *Id.*
[30] *Id.*
[31] *Id.*
[32] *Id.*
[33] *Id.* at 181.
[34] *Id.* at 178.
[35] *Id.* at 181.

Schlumberger the Court explicitly refused to adopt a per se rule to that effect.[36]

The Court held that the release in *Schlumberger* was effective to bar a fraudulent inducement claim against Schlumberger. To come to that conclusion, the Court emphasized that "[t]he contract and the circumstances surrounding its formation determine whether the disclaimer of reliance is binding."[37] Thus, the circumstances in the release that the Swansons granted to Schlumberger were particularly important.[38]

Several factors surrounding the release in *Schlumberger* persuaded the Court to rule that the release barred any claim by the Swansons for fraudulent inducement: 1) presence of counsel, 2) sophistication of the parties involved, 3) awareness of a dispute, and 4) the specific language of the release.[39]

Key to the Court's decision was the fact that counsel represented the Swansons.[40] The Court noted that "[i]n negotiating the release, highly competent and able legal counsel represented both parties and, as we have said above, the parties were dealing at arm's length."[41] The presence of counsel for the Swansons helped to ensure that the Swansons fully understood the effect of their release and that the Swansons were not being taken advantage of by Schlumberger.

The Court also noted that the sophistication of the Swansons added further reason for the release to be upheld.[42] The Swansons' family had been in the diamond mining business in South Africa for several decades.[43] The sophistication of the Swansons was further demonstrated when the Swansons "disagreed with Schlumberger about the feasibility and value of the sea-diamond project."[44] The Swansons were "knowledgeable and sophisticated business players" who ignored their instinct about the project.[45] Given their sophistication, it was much more likely that the Swansons understood the risks and effect of their release to Schlumberger.

The Court also focused on the fact that, when the release was signed, Schlumberger and the Swansons were involved in a dispute, the subject of which was the object of the release.[46] In the text of the release itself, it stated that "there is considerable doubt, disagreement, dispute and controversy" as to the value of the project.[47] Partially because the release specifically mentioned the subject matter of the dispute, the Court ruled that the release barred the Swansons from succeeding on a subsequent fraudulent inducement claim.

The Court also focused on the language of the release.[48] The release in *Schlumberger* was remarkably specific as to subject matter and broad as to scope.[49] In it, the Swansons released Schlumberger of liability for all "causes of action of whatsoever nature, or any other legal theory arising out of the circumstances described above, from any and all liability damages of any kind known or unknown, whether in contract or in tort."[50] As indicated by the remarkably broad language in the release and specific description of the subject matter about which the release pertained, the Swansons effectively "unequivocally disclaimed reliance upon representations by Schlumberger about the project's feasibility and value."[51]

As noted above, the Court in *Schlumberger* emphasized that, when evaluating the effectiveness of a reliance disclaimer, "[t]he contract and the circumstances surrounding its formation determine whether the disclaimer of reliance is binding."[52] Thus, *Schlumberger* confirmed that reliance disclaimers can be upheld by the courts. However, it also emphasized that certain factors, such as presence of counsel, sophistication of the parties, presence of a dispute, and broad release language, should be present for a reliance disclaimer to be upheld. The circumstances of

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[36] *Id.* at 178.
[37] *Id.* at 179 (citing *Columbia Gas Transmission Corp. v. New Ulm Gas, Ltd.*, 940 S.W.2d 587, 591 (Tex. 1996)).
[38] *Id.* at 180.
[39] *Id.* at 179–80.
[40] *Id.* at 180.
[41] *Id.*
[42] *Id.* at 180.
[43] *Id.* at 172.
[44] *Id.* at 180.
[45] *Id.*
[46] *Id.* at 180.
[47] *Id.*
[48] *Id.*
[49] *Id.*
[50] *Id.*
[51] *Id.*
[52] *Id.* at 179.

each particular case must be examined to see if the release is binding.

B. *Forest Oil*: A Clarification of *Schlumberger*

In *Forest Oil Corp. v. McAllen*, the Court clarified its ruling in *Schlumberger* and provided additional guidance to transactional lawyers in drafting enforceable reliance disclaimers.[53] Forest Oil, the defendant in the original action, "settled a long-running lawsuit over oil and gas royalties and leasehold development with [the plaintiffs,] James McAllen and others with interests in the McAllen Ranch."[54] The settlement agreement between the parties disclaimed reliance "upon any statement or any representation of any agent of the parties."[55] Importantly, the release also reserved the right to arbitrate any further claims.[56]

When the plaintiffs later sued Forest Oil for environmental damage and personal injuries, grounds unrelated to the release, Forest Oil "sought to compel arbitration under the settlement agreement."[57] In response, the plaintiffs alleged that "the arbitration provision was induced by fraud" and, thus, was unenforceable.[58] Even though the reliance agreement was written somewhat generally and the fraudulent inducement claim did not relate directly to the subject matter of the release, the Texas Supreme Court held that the reliance disclaimer was binding.[59]

Basing its ruling on *Schlumberger*, the Supreme Court first refuted plaintiffs' attempts to distinguish the case from *Schlumberger.*[60] Plaintiffs' first attempt to distinguish *Schlumberger* asserted that the cases were distinguishable because *Schlumberger* "focuses on representations that were made regarding the underlying agreement's core subject matter" and, in this case, "the litigation that led to the 1999 settlement concerned royalty underpayments and mineral underdevelopment, issues having nothing to do with the environmental and personal-injury torts that sparked the current litigation and were excepted from the settlement agreement."[61] In essence, the plaintiffs argued that the reliance disclaimer was unenforceable because the alleged misrepresentations "did not concern known disputed matters."[62]

However, the Court was not swayed by this distinction. It held that reliance disclaimers in which parties agree to "settle present disputes and arbitrate future ones" need not be narrowly tailored to specific disputes to be enforceable. When the plaintiffs argued that "the settled dispute [in *Schlumberger*] was the only dispute" and that the agreed-to disclaimer was insufficiently specific to be applied to this context, the Court remained unswayed, stating that "[a]n all-embracing disclaimer of any and all representations, as here, shows the parties' clear intent."[63] Importantly, the Court stated that a "once and for all" release could "constitute an *additional* factor urging rejection of fraud-based claims."[64]

After concluding that the plaintiffs' dispute-based distinctions were meritless, the Court examined the specific language of the release and an argument that fraudulent inducement "is essentially a meeting-of-the-minds argument."[65] On both counts, the Court ruled that the reliance disclaimer was binding.[66]

After disposing with all of the plaintiffs' arguments, the *Forest Oil* Court clarified the factors outlined in *Schlumberger* to guide Texas courts in the future. It noted that the following five factors played the biggest part in guiding its reasoning in *Schlumberger*:

(1) the terms of the contract were negotiated, rather than boilerplate, and during negotiations the parties specifically discussed the issue which has become the topic of the subsequent dispute;
(2) the complaining party was represented by counsel;

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[53] 268 S.W.3d 51 (Tex. 2008).
[54] *Id.* at 53.
[55] *Id.* at 54.
[56] *Id.*
[57] *Id.* at 54–55.
[58] *Id.* at 55.
[59] *Id.* at 61.
[60] *Id.* at 57.
[61] *Id.*
[62] *Id.*
[63] *Id.* at 58.
[64] *Id.*
[65] *Id.* at 59–60.
[66] *Id.*

(3) the parties dealt with each other in an arm's length transaction;
(4) the parties were knowledgeable in business matters; and
(5) the release language was clear.[67]

The Court then noted that the above factors, those which were most relevant in *Schlumberger*, were present in the instant case. Therefore, the disclaimer release was binding.[68]

C. *Italian Cowboy*: The Court Addresses Merger Clauses

In *Italian Cowboy Partners, Ltd. v. Prudential Insurance Co. of America, et al.*, the Court addressed the effect of a contractual merger clause on fraud claims.[69] The case concerned a dispute over a commercial real estate lease. The dispute arose when the owners of a restaurant known as the Italian Cowboy terminated their lease because of an unrelenting sewer gas odor.[70] The owners filed suit against the landlord (Prudential) and the property manager (Prizm Partners) for, among other things, fraud damages.[71] In support of their claims, the restaurant owners claimed that an employee of the property manager who negotiated the lease made a number of false representations. Specifically, the plaintiffs alleged that they were told that the building was practically new and had no problems.[72] During the build-out of the leased premises, the plaintiffs alleged that the property manager repeatedly denied prior odor problems.[73]

During construction of the new restaurant, the owners detected a sewer odor, which at first subsided, but then was detected again just before the opening.[74] A number of measures were taken to remedy the odor, but none were successful.[75] Hoping that the problem would soon be identified, the plaintiffs opened the restaurant, but the odor persisted.[76] Eventually, the owners learned that the property manager had been aware of prior odor problems experienced by the prior tenant.[77] Upon learning this information, the owners stopped paying rent, closed the restaurant, and filed suit.[78]

The trial court found for the plaintiffs, determining that the property manager had made fraudulent representations. The trial court awarded rescission, $600,070.40 in damages, prejudgment interest and attorneys' fees, and $50,000 in exemplary damages.[79] The court also held that Prudential take nothing on its counterclaim for unpaid rent.[80] The court of appeals reversed the judgment in favor of the restaurant owners and reversed and rendered judgment in favor of Prudential on its clam for unpaid rent.[81]

In the appeal to the Texas Supreme Court, the defendants argued that the appellate court correctly reversed the judgment in favor of the restaurant owners because of the contractual disclaimers of reliance contained in the parties' lease agreement. There were two provisions relevant to this issue. The first was a provision addressing representations:

> **14.18 *Representations.*** Tenant acknowledges that neither Landlord nor Landlord's agents, employees or contractors have made any representations or promises with respect to the Site, the Shopping Center or this Lease except as expressly set forth herein.

The second was a merger clause:

> **14.21 *Entire Agreement.*** This lease constitutes the entire agreement between the parties hereto with respect to the subject matter hereof, and no subsequent amendment or agreement shall be

[67] *Id.* at 60.
[68] *Id.* It should be noted that, in *Forest Oil*, the Court refused to adopt a per se test. *Id.* According to the Court, context is always important. *Id.*
[69] 341 S.W.3d 323 (Tex. 2011).
[70] *Id*. at 328.
[71] *Id*.
[72] *Id.*
[73] *Id*. at 330.
[74] *Id*. at 329.
[75] *Id*.
[76] *Id*.
[77] *Id*. at 329–330.
[78] *Id*. at 330.
[79] *Id*. at 331.
[80] *Id*.
[81] *Id*.

> binding upon either party unless it is signed by each party….[82]

The Court held that these contractual provisions did not effectively disclaim reliance on representations made by the landlord and its property manager. The Court began its analysis by observing that a contract can be avoided when it is fraudulently induced.[83] This is true even when the agreement at issue contains a merger clause.[84]

The Court then turned to a review of its prior decisions regarding contractual reliance disclaimers. The Court noted that in *Schlumberger* it had "held that when sophisticated parties represented by counsel disclaim reliance on representations about a specific matter in dispute, such a disclaimer may be binding, conclusively negating the element of reliance in a suit for fraudulent inducement."[85] The Court noted that the disclaimer at issue in *Schlumberger* was specific to a particular dispute and specific representations between the parties.[86]

The Court then proceeded to discuss its approval of broader, "more inclusive" release language in its decision in *Forest Oil*, which concerned language in a settlement agreement addressing present and future claims between the parties.[87] It expressly noted, however, its warning in *Forest Oil* that the "holding should not be construed to mean that mere disclaimer language standing alone will forgive intentional lies regardless of context" and that the Court had expressly declined to adopt any per se rule.[88]

The Court then turned to the specific arguments of the parties. The defendants asserted that Section 14.18 of the contract implicitly disclaimed reliance on representations because it was an agreement that no representations had been made.[89] The Court rejected that this necessarily disclaimed reliance on external representations. The Court pointed out that merger clauses often contain similar language and that "[s]uch language achieves the purpose of ensuring that the contract at issue invalidates or supersedes any previous agreements, as well as negating the apparent authority of an agent to later modify the contract's terms."[90] Accordingly, the Court concluded that the parties simply intended nothing more than a standard merger clause, rather than any specific disclaimer of reliance on external representations.[91]

Having construed the contractual provisions as simply an effort to provide for a merger clause, the Court went on to observe that, absent an "express and unequivocal intent to disclaim reliance or waive claims for fraudulent inducement," merger clauses have never been held to have that effect.[92] The Court also distinguished the facts before it from those present in its prior decisions in *Schlumberger* and *Forest Oil*. The Court noted that in both of these prior cases, the contractual language at issue made clear on its face the intent to disclaim reliance on others' representations.[93] The Court went on to explain the difference in more detail:

> There is a significant difference between a party disclaiming its *reliance* on certain representations, and therefore potentially relinquishing the right to pursue any claim for which reliance is an element, and disclaiming the *fact* that no other representations were made.[94]

The Court also pointed out the different purposes underlying the lease agreement on the one hand and the agreements at issue in *Schlumberger* and *Forest Oil* on the other. In the prior cases, "the parties intended once and for all to resolve specific disputes."[95] In the lease agreement before the Court in *Italian Cowboy*, the agreement was the initiation of a relationship between the parties, which meant that any disclaimer language should be "all the more clear and unequivocal in effectively

[82] *Id*.
[83] *Id*. at 331.
[84] *Id*.
[85] *Id*. at 332.
[86] *Id*. at 332–33.
[87] *Id*. at 333.
[88] *Id*. (quoting *Forest Oil*, 268. S.W.3d. at 61).
[89] *Id*. at 334.
[90] *Id*.
[91] *Id*.
[92] *Id*. at 334–35.
[93] *Id*. at 335.
[94] *Id*.
[95] *Id*.

disclaiming reliance and precluding a claim for fraudulent inducement."[96]

After conducting the foregoing analysis, the Court announced its holding, refusing to find an effective disclaimer of reliance in the parties' lease agreement:

> We have repeatedly held that to disclaim reliance, parties must use clear and unequivocal language. *See Forest Oil*, 268 S.W.3d at 62; *Schlumberger*, 959 S.W.2d at 179–80. This elevated requirement of precise language helps ensure that parties to a contract—even sophisticated parties represented by able attorneys—understand that the contract's terms disclaim reliance, such that the contract may be binding even if it was induced by fraud. Here, the contractual language was not clear or unequivocal about disclaiming reliance. For instance, the term "rely" does not appear in any form, either in terms of relying on the other party's representations, or in relying solely on one's own judgment….
>
> We decline to extend our holdings in *Schlumberger* and *Forest Oil*—each of which included clear and unequivocal language expressly disclaiming reliance on representations, and representing reliance on one's own judgment—to the generic merger language contained in the contract at issue in this case. As a matter of law, the lease agreement at issue does not disclaim reliance, and thus does not defeat Italian Cowboy's claim for fraudulent inducement.[97]

The Court reversed the trial court, rendering judgment in favor of the restaurant owners as to certain other issues addressed in the Court's opinion and remanding the case back to the appellate court for consideration of whether factually sufficient evidence existed to support liability for fraud.[98]

The Court's opinion in *Italian Cowboy* is a reminder of the strict requirements for enforceability of contractual disclaimers of reliance. It is also a warning that boilerplate merger clauses will simply not be effective in disclaiming reliance on external representations. Accordingly, counsel drafting agreements where a contractual disclaimer of reliance on external representations is desirable should carefully craft the language to comport with the factors set forth in *Schlumberger* and clarified and explained in *Forest Oil*. Effective disclaimer language cannot consist of boilerplate, one size fits all language, nor can it consist of a merger clause.

VI. The SEC's New Whistleblower Program

On May 25, 2011, the Securities and Exchange Commission adopted final rules establishing a whistleblower program as required by the Dodd-Frank Act. The SEC's whistleblower program is designed to incentivize individuals to provide information to the SEC that will lead to enforcement actions. In addition to financial incentives, the whistleblower program also provides for various protections for employees of a company who provide information under the program. While a full discussion of the program and its various provisions are beyond the scope of this paper, a brief discussion of some of the highlights of the program is useful so that companies and their counsel can understand and plan for the new environment in which they operate. While the whistleblower program certainly provides incentives to ferret out illegal conduct, it could also have unintended consequences that are not as laudable.

The SEC's whistleblower program provides for new cash incentives for certain individuals who report suspected wrongdoing to the SEC. The SEC rules require that the information be "original information" that leads

[96] *Id*.
[97] *Id*. at 336.

[98] *Id*. at 347. Although the trial court's damage award was already supported by the Court's decision to reverse and render on a claim for breach of the implied warranty of suitability, the factual sufficiency of the fraud claim had to be resolved because it was the basis for the trial court's award of exemplary damages.

to a "successful enforcement action."[99] In order to be eligible for the program, the whistleblower must provide the information "voluntarily" to the SEC.[100] To qualify for an award under the program, the "original information" provided by the individual must lead to the SEC's recovery of an aggregate monetary sanction exceeding $1 million.[101] Certain individuals are ineligible for the program, such as employees of law firms investigating potential violations of law at the company.[102]

If the whistleblower qualifies for an award, the amount of award will range from 10% to 30% of the sanctions collected.[103] The precise percentage is determined by the SEC in its discretion based on a number of factors. The factors that may lead to an increased award include the following: (1) "the significance of the information provided by a whistleblower to the success of the [SEC] action or related action"; (2) "the degree of assistance provided by the whistleblower and any legal representative of the whistleblower in the [SEC] action or related action"; (3) the SEC's "programmatic interest in deterring violations of the securities laws by making awards to whistleblowers who provide information that leads to the successful enforcement of such laws"; and (4) "whether, and the extent to which, the whistleblower and any legal representative of the whistleblower participated in internal compliance systems."[104] The factors that may lead to a decreased award include the following: (1) "the culpability or involvement of the whistleblower in matters associated with the [SEC's] action or related action"; (2) "whether the whistleblower unreasonably delayed reporting the securities violations"; and (3) "in cases where the whistleblower interacted with his or her entity's internal compliance or reporting system, whether the whistleblower undermined the integrity of such system."[105]

A key criticism of the program was the concern that it would incentivize employees to avoid the company's compliance system because it may prove more lucrative to report concerns to the SEC instead of the company. The whistleblower program attempts to address these concerns in a few ways. For example, a whistleblower remains eligible for an award if they report the information through a company's internal compliance program before or at the same time the information is provided to the SEC. In addition, as noted above, a lower award may be granted if the employee undermines the company's compliance program.

The SEC rules also provide important anti-retaliation protections for whistleblowers. These protections apply regardless of whether the information leads to a successful enforcement action if the whistleblower possesses "a reasonable belief" that the information relates to a possible securities law violation.[106] Among the protections afforded are the following: (1) an extension of the statute of limitations to bring retaliation claims to as much as 6 years; (2) the exemption of whistleblower claims from pre-dispute arbitration agreement; (3) the right to bypass the administrative process to bring claims directly in federal court; (4) a clarification that a whistleblower has a right to a jury trial on retaliation for SOX whistleblower claims; and (5) potential relief that includes reinstatement, double back pay, and litigation costs and attorneys' fees.[107]

The potential impacts of this program need to be considered by the company. For example, employees may now be actively looking for information that can be used to either obtain a reward or the protection of the anti-retaliation provisions. This may influence a company's decision as to whether to self-report potential wrongdoing to the SEC. A company may also want to consider certain protective measures, such as modifying the company's exit interview procedures and documentation to include a representation that the employee has reported any potential wrongdoing to the company. The company may also need to modify its policies and procedures to address potential whistleblower situations. These are just some of the many actions that a company may want to consider in responding to these new measures.

[99] 17 C.F.R. § 240.21F-2–240.21F-4, 240.21F-6.
[100] *Id.* § 240.21F-3–240.21F-4.
[101] *Id.*
[102] *Id.* § 240.21F-4(b)(4).
[103] *Id.* § 240.21F-5(b).
[104] *Id.* § 240.21F-6(a)(1)–(4).
[105] *Id.* § 240.21F-6(b)(1)–(3).
[106] *Id.* § 240.21F-2(b)(1).
[107] *Id.*; 15 U.S.C. §78u-6(h)(1).

VII. The Expansion Of Enforceable Non-Competition Agreements

In *Marsh USA Inc., et al. v. Cook*, the Texas Supreme Court revisited what constitutes proper consideration for a non-competition agreement.[108] Texas courts have long considered only certain forms of consideration, such as specialized training or confidential information, as valid for non-competition agreements. This stems from the Texas Supreme Court's decision seventeen years ago in *Light v. Centel Cellular Co. of Texas*.[109] In that decision, the Supreme Court held that the consideration for the non-competition agreement must "give rise to the employer's interest in restraining the employee from competing."[110] In *Marsh USA*, the Texas Supreme Court abandoned this rule, providing employers with substantially more flexibility in obtaining enforceable non-competition agreements with employees.

The employee at issue in *Marsh USA* was a managing director at Marsh USA ("Marsh"), a subsidiary of Marsh & McLennan Companies ("MMC").[111] In 1996, the employee was offered the option to purchase 500 shares of MMC stock pursuant to MMC's 1992 Incentive and Stock Award Plan.[112] Pursuant to the terms of the MMC Plan, the option was to vest in 25% increments each year, thereby becoming fully vested within four years.[113] The MMC Plan required employees wanting to exercise a stock option to, among other things, execute a Non-Solicitation Agreement.[114] In 2005, the employee desired to exercise the stock option granted in 1996 and now fully vested. As a result, the employee executed a Non-Solicitation Agreement.[115] The Non-Solicitation Agreement contained a non-competition agreement providing that the employee would not compete for a two-year period in the event that the employee left within three years of exercising the option.[116] The Non-Solicitation Agreement also contained a promise that the employee would keep MMC's confidential information and trade secrets confidential.[117]

Less than three years later, the employee resigned from Marsh and was employed by a direct competitor of MMC.[118] As a result, MMC filed suit against the employee and his new employer based, in part, on the employee's breach of the non-competition provisions contained in the Non-Solicitation Agreement.[119] The defendants responded by moving for summary judgment asserting that the non-competition agreement was unenforceable.[120] The trial court held that the non-competition agreement was unenforceable and the appellate court affirmed.[121]

The Court began by noting that the agreement was governed by Texas's Covenants Not to Compete Act (the "Act").[122] The Court then went on to discuss the policy considerations underlying the Act,[123] and summed up the purpose of the Act as follows:

> The Legislature . . . crafted the Act to prohibit naked restrictions on employee mobility that impede competition while allowing employers and employees to agree to reasonable restrictions on mobility that are ancillary to or part of a valid contract having a primary purpose that is unrelated to restraining competition between the parties.[124]

As a result, the Act provides that naked restraints on competition—that is, non-competition agreements whose sole purpose is to restrain competition— are unlawful.[125] The Court explained that this prohibition on naked restraints of trade provides "the basis for the requirement that the covenant be ancillary to a valid contract or transaction having a primary purpose that is unrelated to restraining

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[108] No. 09-0558, 2011 WL 2517019 (Tex. June 24, 2011).
[109] 883 S.W. 2d 642 (Tex. 1994).
[110] *Id*. at 647.
[111] *Marsh USA Inc.*, 2011 WL 2517019 at *1.
[112] *Id*.
[113] *Id*.
[114] *Id*.
[115] *Id*.
[116] *Id*. at *1–2.
[117] *Id*.
[118] *Id*. at *2.
[119] *Id*.
[120] *Id*.
[121] *Id*.
[122] *Id*.
[123] *Id*. at *3–4.
[124] *Id*. at *1–2.
[125] *Id*.

competition between the parties."[126] The Court then explained that it employs a two step analysis in analyzing this requirement: "First, we determine whether there is an 'otherwise enforceable agreement' between the parties, then we determine whether the covenant is 'ancillary to or part of' that agreement."[127]

The Court then traced the history of Texas non-compete law.[128] For many years, Texas courts enforced reasonable non-competition agreements.[129] In *Justin Belt Co. v. Yost*, 502 S.W.2d 681 (Tex. 1973), the Court "articulated for the first time the common law requirement recognized by courts of appeals in Texas and other states that a covenant not to compete must be 'ancillary' to another contract, transaction or relationship."[130] In *Hill v. Mobile Auto Trim*, 725 S.W.2d 168 (Tex. 1987), the Court limited the enforceability of non-competition agreements by holding that the an employee could not be restrained from accepting a job that shares a "common calling" with their current employer. The Texas courts had historically enforced reasonable non-competition clauses. This led to the passage of the Act, which

> was intended to reverse the Court's apparent antipathy to covenants not to compete and specifically to remove the obstacle to their use presented by the narrow "common calling" test instituted by *Hill*, and to "restore over 30 years of common law developed by Texas Courts and remove an impairment to economic development in the state."[131]

The Act was passed while the landmark case of *DeSantis v. Wackenhut Corp.*, 793 S.W.2d 670 (Tex. 1990), was pending.[132] In *DeSantis*, the Court interpreted the reinstitution of prior common law to require that non-competition agreements must be "part of and subsidiary to an otherwise valid transaction or relationship which gives rise to an interest worthy of protection."[133]

The Court observed that none of the parties in *Marsh* contested that an "otherwise enforceable agreement" existed.[134] Accordingly, the Court turned to analyze whether the covenant not to compete was "ancillary to or part of" that agreement.

In *Light v. Centel Cellular Co. of Texas*, the Court established a two-prong test for evaluating whether a covenant was "ancillary to or part of" an otherwise enforceable agreement.[135] This test required:

> (1) [T]he consideration given by the employer in the otherwise enforceable agreement must give rise to the employer's interest in restraining the employee from competing; and (2) the covenant must be designed to enforce the employee's consideration or return promise in the otherwise enforceable agreement.

The Court stated that it intended to reexamine the "give rise" requirement contained in *Light*'s two-prong test.[136]

The Court observed that the "give rise" requirement is not contained in the Act, but was first articulated by the Court in *DeSantis.*[137] In *DeSantis*, the "give rise" requirement was defined as requiring that the agreement "must give rise to an interest worthy of protection."[138] In *Light*, the "give rise" requirement was redefined to require that the agreement must "give rise to the employer's interest in restraining the employee from competing."[139]

The Court found that *Light*'s alteration of the "give rise" requirement "was more restrictive than the common law rule the Legislature intended to resurrect" in the Act.[140] The Court noted that *Light* largely precluded other protectable business interests, such as goodwill, from supporting a valid non-

[126] *Id*.
[127] *Id*.
[128] *Id*. at *5–9.
[129] *Id*. at *5.
[130] *Id*.
[131] *Id*. at *6 (quoting *Alex Sheshunoff Mgmt. Servs., L.P. v. Johnson*, 209 S.W.3d 644, 653 (Tex. 2006) (quoting House Research Org., Bill Analysis, Tex. S.B. 946, 71st Leg., R.S. (1989))).
[132] *Id*.
[133] *Id*. (quoting *DeSantis*, 793 S.W.2d at 682.)
[134] *Id*. at *6.
[135] 883 S.W.2d 642, 647 (Tex. 1994).
[136] *Marsh,* 2011 WL2517019 at *7.
[137] *Id*.
[138] *Id*. (quoting *DeSantis*, 793 S.W.2d at 682).
[139] *Id*. (quoting *Light*, 883 S.W.2d at 647).
[140] *Id*.

competition agreement.[141] As a result, it has been largely viewed that only a promise not to disclose trade secrets or confidential information would satisfy the *Light* "give rise" requirement.[142]

The Court pointed out that the Act did not contain a "give rise" requirement, but simply required that the non-competition agreement must be "ancillary" to the otherwise enforceable agreement. The Act provides as follows:

> Notwithstanding section 15.05 of this code, and subject to any applicable provision of Subsection (b), a covenant not to compete is enforceable if it is ancillary to or part of an otherwise enforceable agreement at the time the agreement is made to the extent that it contains limitations as to time, geographical area, and scope of activity to be restrained that are reasonable and do not impose a greater restraint than is necessary to protect the goodwill or other business interest of the promisee.[143]

The Court found that the term "ancillary" should simply be given its ordinary meaning, rather than the highly restrictive and narrow meaning imposed by the test in *Light*:

> Turning to the "give rise" question, the Legislature did not include a requirement in the Act that the consideration for the noncompete must give rise to the interest in restraining competition with the employer. Instead, the Legislature required a nexus—that the noncompete be "ancillary to" or "part of" the otherwise enforceable agreement between the parties. TEX. BUS. & COM. CODE § 15.50(a). There is nothing in the statute indicating that "ancillary" or "part" should mean anything other than their common definitions. "[A]ncillary means 'supplementary' and part means 'one of several . . . units of which something is composed.'" *Sheshunoff*, 209 S.W.3d at 541, 665 (Wainwright, J., concurring) (quoting WEBSTER'S NINTH NEW COLLEGIATE DICTIONARY 84, 857 (9th ed.1990)).[144]

With this rejection of *Light*'s "give rise" requirement, the Court turned to analyze the enforceability of the non-competition agreement in *Marsh*. The Court found that the stock option agreement aligned the employer's interest with the interest of the employee.[145] By providing ownership to the employee, the employee now had an interest in protecting the company's goodwill.[146] The non-competition agreement, in turn, sought to protect the company's goodwill by fostering long-term employer-client relationships.[147] The Court found that this goodwill was an interest worthy of protection, noting that the Act itself provides that goodwill is a protectable interest.[148] Accordingly, the Court found that the non-competition agreement was "ancillary to or part of" an otherwise enforceable agreement and remanded the case to the appellate court for consideration of other challenges to the agreement.[149]

What does *Marsh* mean for employers? It provides substantially more flexibility in entering into non-competition agreements with employees. As noted above, the only agreements that were seen as valid "ancillary" agreements were agreements to not disclose trade secrets or confidential information. Employers now potentially have the ability to negotiate and enter into non-competition provisions in connection with a variety of other types of agreements. Stock option agreements are certainly one such type of agreement. To the extent that other types of agreements serve to protect the goodwill of the company or some other protectable interest, the holding in *Marsh* may allow employers more flexibility to include non-competition provisions in such agreements.

VIII. Recent Delaware Cases Impacting The Role Of Investment Banks In M&A Transactions

Two recent Delaware Chancery Court opinions address important issues surrounding the role of investment bankers in M&A transactions. Investment bankers are typically retained to advise a company in connection with a potential merger or acquisition and usually

141 *Id.*
142 *Id.*
143 TEX. BUS. & COM. CODE § 15.50(a).
144 *Id.* at *9.
145 *Id.* at *11.
146 *Id.*
147 *Id.*
148 *Id.*
149 *Id.* at *14.

provide a fairness opinion as to whether the proposed transaction is fair from a financial point of view. Because this opinion is critical to the closing of any merger, and very likely relied on heavily by shareholders, Delaware courts closely monitor the role of investment banks and related disclosures to investors in the company's proxy statement.

In *In re Atheros Communications, Inc.*,[150] Vice Chancellor Noble reviewed the adequacy of disclosures relating to the compensation of the investment banker advising the target company. Typically, investment bankers closely guard information regarding their fee structure, as this is seen as confidential information. The decision in *In re Atheros* makes it clear that there are situations where specific disclosure of the fee structure is necessary.

The case arose out of the proposed acquisition of Atheros by Qualcomm.[151] Atheros retained Qatalyst Partners LP as its financial advisor for the transaction.[152] Atheros and Qatalyst entered into negotiations over the fee terms of engagement.[153] Ultimately, just days before the merger agreement was approved, the parties agreed to a fee arrangement.[154] The fee agreement provided that Qatalyst would be paid a flat fee, 98% of which was contingent on the closing of the transaction.[155]

The proxy statement filed by Atheros addressed the compensation of its financial advisor. The proxy statement disclosed that Qatalyst would "be paid a customary fee, a portion of which is payable in connection with the rendering of its opinion and a substantial portion of which will be paid upon completion of the Merger."[156]

The court held that this disclosure was not sufficient to adequately inform shareholders of the potential conflict of interest created by the fee arrangement. The court began by noting the critical role that financial advisors play in such transactions:

> Financial advisors, such as Qatalyst, serve a critical function by performing a valuation of the enterprise upon which its owners rely in determining whether to support a sale. Before shareholders can have confidence in a fairness opinion or rely upon it to an appropriate extent, the conflicts and arguably perverse incentives that may influence the financial advisor in the exercise of its judgment and discretion must be fully and fairly disclosed.
>
> Because of the central role played by investment banks in the evaluation, exploration, selection, and implementation of strategic alternatives, this Court has required full disclosure of investment banker compensation and potential conflicts.

The court then turned to the facts of the case at hand. The court noted that the aggregate fee was not disclosed.[157] But, the court found it more important that "a quantification of the amount of the fee that is contingent" was not disclosed.[158] The court found no solace in the disclosure that a "substantial" portion of the fee was contingent, and observed that a 98% contingency exceeded the common understanding of "substantial."[159]

The court was careful to note that there is no "magic percentage" that will require the percentage of the fee that is contingent to be disclosed.[160] This did not stop the court from concluding that disclosure of the percentage was required in this case: "That fixing such a line might be difficult, if perhaps impossible, does not necessitate a conclusion that disclosure of the contingency percentage is always immaterial and of no concern."[161] The court concluded that a 50:1 ratio between the contingent and fixed part of the investment banker's fee was large enough to require disclosure of the percentage.[162]

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[150] No. 6124-VCN, 2011 WL 864928 (Del. Ch. Mar. 4, 2011).
[151] *Id.* at *1.
[152] *Id.* at *2.
[153] *Id.*
[154] *Id.*
[155] *Id.*
[156] *Id.* at *8 (quoting the Atheros proxy).
[157] *Id.*
[158] *Id.*
[159] *Id.*
[160] *Id.* at *9.
[161] *Id.*
[162] *Id.*

The defendants argued that the actual fee amount should not be disclosed.[163] The court expressly did not decide whether, under normal circumstances, disclosing that a fee is customary would suffice.[164] The court nevertheless concluded that, given the late date at which the fee agreement was reached and the high percentage of the fee that was contingent, investors were entitled to know the aggregate amount of the fee.[165] Therefore, the court enjoined the transaction until the curative disclosure was made.[166]

In *In re Del Monte Foods Co. Shareholder Litigation*, Vice Chancellor Laster addressed a different aspect of the role of investment bankers: potential conflicts of interest that arise outside of the fee agreement.[167] In *Del Monte*, Barclays was hired to advise Del Monte with respect to an acquisition bid by Apollo Management, a private equity firm, in January 2010.[168]

Unbeknownst to Del Monte and its board, Barclays coverage officers had previously worked to encourage a bid by KKR, a separate private equity firm and another Barclays client.[169] In doing so, Barclays had the strategic vision that it could potentially obtain not only the role of advising Del Monte with respect to such a transaction, but also potentially obtain lucrative financing fees by arranging financing for KKR's acquisition.[170] Apollo, however, made an offer before KKR could act.[171]

After Del Monte retained Barclays as its advisor, Barclays identified potential other bidders who would be approached for an offer.[172] Barclays identified other private equity firms, which was seen by the court as consistent with its intention of obtaining financing fees as well, since private equity firms would typically require financing assistance for such a transaction.[173] KKR was included in the group of bidders. Each of the bidders executed an agreement to keep the bidding process confidential and to not team up with other bidders to make an offer for the company.[174] Ultimately, Del Monte concluded that all of the bids were insufficient and instructed Barclays to end the process.[175]

Barclays, however, continued to explore the potential for a possible transaction involving Del Monte. In September 2010, Barclays met with Vestar (another of the previous bidders) and suggested that Vestar team up with KKR, despite the fact that both companies were contractually precluded from doing so.[176] Barclays also discussed the notion with KKR.[177] Ultimately, KKR initiated an offer for Del Monte, but purposefully refrained from disclosing Vestar as a partner in the transaction at that time.[178] Barclays advised KKR that it was best to keep Vestar's involvement secret for the time being.[179]

Rather than initiate another round of bidding, Del Monte's board decided to just negotiate with KKR.[180] Del Monte retained Barclays to advise it in the negotiations. Negotiations proceeded and the parties drew closer to a deal.[181] As the deal approached, Barclays acted to attempt to secure lucrative financing fees. On November 8, 2010, Barclays asked KKR to give Barclays one-third of the debt financing for the transaction, and KKR agreed.[182] The next day, Barclays asked Del Monte for permission to participate in the buy-side financing, and Del Monte agreed.[183] One ramification of this decision was that Del Monte was forced to obtain a second fairness opinion due to Barclays' participation in the buy-side financing at an additional cost of $3 million.[184] At about the same time, KKR asked Del Monte for permission to "formally approach" Vestar to

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[163] *Id*.
[164] *Id*.
[165] *Id*.
[166] *Id*. at *14. Also required were additional disclosures regarding the potential future employment of Atheros's CEO with Qualcomm following the transaction.
[167] 25 A.2d 813 (Del. Ch. Feb. 14, 2011)
[168] *Id*. at 819–20.
[169] *Id*. at 819.
[170] *Id*. at 819–20.
[171] *Id*. at 819.
[172] *Id*. at 820–21.
[173] *Id*.
[174] *Id*. at 821.
[175] *Id*. at 822.
[176] *Id*. at 823.
[177] *Id*.
[178] *Id*. at 823–24.
[179] *Id*. at 824.
[180] *Id*. at 824–25.
[181] *Id*.
[182] *Id*. at 826.
[183] *Id*.
[184] *Id*.

partner on the deal, but did not disclose that it had been working with Vestar for months at Barclays' suggestion.[185]

On November 24, 2010, Del Monte agreed to the proposed merger agreement whereby it would be acquired by KKR and Vestar.[186] The merger agreement provided for a "go-shop" period of 45 days, during which Del Monte could shop the deal to see if a more lucrative offer would be made.[187] Barclays was allowed to manage the go-shop process. No alternative bidder emerged.[188]

The plaintiff shareholders sued alleging two claims: (1) that the proxy disclosures were insufficient and/or misleading and (2) that the merger transaction was the result of an improper process in which Del Monte's board failed to act reasonably to pursue the best transaction reasonably available.[189] After discovery revealed Barclays' actions, Del Monte supplemented its proxy disclosures to include the necessary material facts and mooted the disclosure claims, leaving the process claims as the remaining basis for an injunction.[190]

The court noted that in prior decisions it "has examined banker conflicts closely to determine whether they tainted the directors' process."[191] The court concluded that Barclays' actions impermissibly tainted the process.[192] The court noted that, had Del Monte's board known of Barclays' activities, the board would have likely hired a different banker.[193] Even if Barclays had been retained, the court found that Del Monte's board likely would never have agreed to permit Barclays to become involved in the buy-side financing.[194] The court found that Del Monte's board may have taken a myriad of other actions to maintain the integrity of the process.[195]

The court reserved its strongest criticism for Barclays' actions to pair two former bidders together and to request Del Monte's permission to be involved in the buy-side financing:

> Although Barclays' activities and non-disclosures in early 2010 are troubling, what indisputably crossed the line was the surreptitious and unauthorized pairing of Vestar with KKR. In doing so, Barclays materially reduced the prospect of price competition for Del Monte. Vestar had been the high bidder in the early 2010 process, and although Vestar needed a partner, a non-conflicted financial advisor could have teamed Vestar with a different sponsor. It was to address precisely this risk of competition-limiting behavior that Del Monte secured the No Teaming Provision. Barclays' efforts caused Vestar and KKR to violate the No Teaming Provision. Most egregiously, Barclays actively concealed the pairing from the Del Monte Board. It was not until the week of November 8 that KKR "formally requested" to be allowed to partner with Vestar. Barclays continued to hide its involvement and recommended that the pairing be permitted.
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> . . .
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> Barclays similarly crossed the line with its late-stage request for permission to be one of KKR's lead banks. There was no deal-related reason for the request, just Barclays' desire for more fees. Del Monte did not benefit. The immediate consequence was to force Del Monte to spend $3 million to hire a second bank. The more serious consequence was to taint the final negotiations. At the time Barclays made its request, the Merger Agreement was not yet signed, and Barclays and KKR were still negotiating over price. Barclays' internal documents from January and March 2010 had stated that "Barclays will look to participate in the acquisition financing once the Company has reached a definitive agreement with a buyer." But Barclays could not wait.[196]

185 *Id*. at 825.
186 *Id*. at 826–27.
187 *Id*. at 827.
188 *Id*.
189 *Id*. at 817.
190 *Id*. at 828–29.
191 *Id*. at 832.
192 *Id*. at 832–36.
193 *Id*. at 833.
194 *Id*.
195 *Id*.
196 *Id*. at 833–35.

The court also noted other impacts on the process, such as Barclays' conflict in presiding over the go-shop process.[197]

As a result of all of these impacts created by Barclays' conflicts, the court held that Del Monte's board had breached their fiduciary duties by failing to engage in a proper process in considering, negotiating, and entering into the transaction.[198] While it may seem unfair that Barclays' actions created a breach by Del Monte's board, the court noted that ultimately it is the directors that are accountable for overseeing the process.[199] The court also found that KKR had aided and abetted the breach of fiduciary duty.[200] As a result, the court decided to enjoin the transaction and suspend the deal protection terms of the merger for 20 days to determine if alternative bidders would come forward.[201]

These two recent cases underscore the growing focus on investment bankers by the Delaware Court of Chancery. Lawyers advising clients in such deals should pay careful attention to ensure that any actual or potential conflicts of interest are disclosed and that they do not rise to the level of tainting the overall process of the transaction. This will be difficult, as investment bankers are typically loathe to disclose certain details such as compensation arrangements and other competitively sensitive information, but these recent cases should strengthen company counsel's hand in seeking such disclosures.

IX. Conclusion

The foregoing discussion of these recent cases should hopefully inform business lawyers about these areas. Perhaps more importantly, these cases should serve as a reminder that the advice that is rendered to clients can be materially changed by court decisions in short order. Accordingly, it is essential that the practitioner remain up to date on the latest court activity relating to his or her area of practice.

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[197] *Id*. at 835.
[198] *Id*. at 835–36.
[199] *Id*. at 835–36. The court did note that any actual financial liability was remote and that the directors' breach likely only gave rise to the equitable relief of enjoining the transaction. *Id*. at 818.
[200] *Id*. at 836–37.
[201] *Id*. at 844–45.