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CHOICE OF ENTITY DECISION TREE

Byron F. Egan
Biographical Information

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

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

Publications: Mr. Egan writes and speaks about the areas in which his law practice is focused, and is a frequent author and lecturer regarding M&A, governance of corporations, partnerships and limited liability companies, securities laws, and financing techniques. Mr. Egan has written or co-authored the following law journal articles: Corporate Governance: Fiduciary Duties of Corporate Directors and Officers in Texas, 43 Texas Journal of Business Law 45 (Spring 2009); Responsibilities of Officers and Directors under Texas and Delaware Law, XXVI Corporate Counsel Review 1 (May 2007); Entity Choice and Formation: Joint Venture Formation, 44 Texas Journal of Business Law 129 (2012); Choice of Entity Decision Tree After Margin Tax and Texas Business Organizations Code, 42 Texas Journal of Business Law 171 (Spring 2007); Choice of Entity Alternatives, 39 Texas Journal of Business Law 379 (Winter 2004); Choice of State of Incorporation – Texas Versus Delaware: Is it Now Time to Rethink Traditional Notions, 54 SMU Law Review 249 (Winter 2001); M & A: Confidentiality Agreements are Contracts with Long Teeth, 46 Texas Journal of Business Law 1 (Fall 2014); Private Company Acquisitions: A Mock Negotiation, 116 Penn St. L. Rev. 743 (2012); Asset Acquisitions: Assuming and Avoiding Liabilities, 116 Penn St. L. Rev. 913 (2012); Asset Acquisitions: A Colloquy, X U. Miami Business Law Review 145 (Winter/Spring 2002); Securities Law: Major Themes of the Sarbanes-Oxley Act, 42 Texas Journal of Business Law 339 (Winter 2008); Communicating with Auditors After the Sarbanes-Oxley Act, 41 Texas Journal of Business Law 131 (Fall 2005); The Sarbanes-Oxley Act and Its Expanding Reach, 40 Texas Journal of Business Law 305 (Winter 2005); Congress Takes Action: The Sarbanes-Oxley Act, XXII Corporate Counsel Review 1 (May 2003); and Legislation: The Role of the Business Law Section and the Texas Business Law Foundation in the Development of Texas Business Law, 41 Texas Journal of Business Law 41 (Spring 2005).

Education: Mr. Egan received his B.A. and J.D. degrees from the University of Texas. After law school, he served as a law clerk for Judge Irving L. Goldberg on the United States Court of Appeals for the Fifth Circuit.

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

Publications

Paper by Byron F. Egan on Choice of Entity Decision Tree for Advanced Business Law Course in Houston on November 20, 2015:

- *Choice of Entity Decision Tree*, TexasBarCLE & Business Law Section of State Bar of Texas Advanced Business Law Course, Houston, November 20, 2015 ("***Choice of Entity paper***"): http://www.jw.com/publications/article/2112
- Also see:
  - *Acquisition Structure Decision Tree*, TexasBarCLE & Business Law Section of State Bar of Texas Choice and Acquisition of Entities in Texas Course, San Antonio, May 22, 2015 ("***Acquisition Structure paper***"): http://www.jw.com/publications/article/2051
  - *How Recent Fiduciary Duty Cases Affect Advice to Directors and Officers of Delaware and Texas Corporations*, University of Texas School of Law 36th Annual Conference on Securities Regulation and Business Law, Dallas, February 13, 2015 ("***Fiduciary Duty paper***"): http://www.jw.com/publications/article/2033
  - *Joint Venture Governance and Business Opportunity Issues*, University of Texas School of Law 11th Annual Mergers and Acquisitions Institute, Dallas, October 15, 2015 ("***Joint Venture paper***"): http://www.jw.com/publications/article/2093

Five Business Entity Forms

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

Texas Secretary of State – Statistical Information

Certificates of Formation Filed for Calendar Year 2014	
Domestic For-Profit Corporation	23,767
Domestic Limited Liability Company	126,085
Domestic Limited Partnership	5,854
Domestic Nonprofit	10,611
Domestic Professional Corporation	811
Domestic Professional Association	708
Domestic Limited Liability Partnership Statistics for Calendar Year 2014	
Registrations of Domestic Limited Liability Partnership	758
Renewals of Domestic LLP Registrations	3,031

Texas Secretary of State – Statistical Information

MASTER FILE STATISTICS FOR December 31, 2014	
Entity Type	Active Entities
Domestic For-Profit Corporation	370,070
Domestic Limited Liability Company	653,326
Domestic Limited Partnership	133,314
Domestic Nonprofit	127,525
Domestic Professional Corporation	17,828
Domestic Professional Association	18,619

Delaware Secretary of State – Statistical Information

Certificates of Formation Filed for Calendar Year 2014	
Domestic For-Profit Corporation	36,445
Domestic Limited Liability Company	121,592
Domestic Limited Partnership	9,637
Master File Statistics for December 31, 2014	
Entity Type	Active Entities
Domestic For-Profit Corporation	282,637
Domestic Limited Liability Company	725,504
Domestic Limited Partnership	82,442

Texas Business Organizations Code

- Enacted by the Texas Legislature in 2003.
- Referred to as "***TBOC***" or "***Code***".
- Became effective for new entities formed under Texas law after January 1, 2006. [TBOC §§ 1.002(20); 402.001]
- After January 1, 2010, TBOC governs all Texas entities. [TBOC § 402.005]

Texas Business Organizations Code

- Entities in existence on January 1, 2006 <u>must</u> conform to TBOC from and after January 1, 2010
- TBOC § 402.005, as amended in 2011, provides in relevant part:

  (a) On or after January 1, 2010, if a domestic entity formed before January 1, 2006, or a foreign filing entity registered with the secretary of state to transact business in this state before January 1, 2006, has not taken the actions specified by Section 402.003 or 402.004 to elect to adopt this code:

  (1) this code applies to the entity and all actions taken by the managerial officials, owners, or members of the entity, except as otherwise expressly provided by this title;

  (2) if the entity is a domestic or foreign filing entity, the entity is not considered to have failed to comply with this code if the entity's certificate of formation or application for registration, as appropriate, does not comply with this code;

  (3) if the entity is a domestic filing entity, the entity shall conform its certificate of formation to the requirements of this code when it next files an amendment to its certificate of formation; and

  (4) if the entity is a foreign filing entity, the entity shall conform its certificate of formation to the requirements of this code when it next files an amendment to its certificate of formation.

  ***

  (c) A domestic or foreign filing entity is not considered to have failed to comply with Subsection (a)(3) or (4) because:

  (1) the certificate of formation does not state the type of entity formed;

  (2) the application for registration or any amendment to the registration:

  (A) does not state the entity's type; or

  (B) does not include the appointment of the secretary of state as agent for service of process, notice, or demand under the circumstances provided by Section 5.251; or

  (3) a circumstance described by Section 402.0051 applies [effect of references to prior law; use of synonymous terms].

- Since entity must conform certificate of formation to TBOC when it next files amendment to its certificate of formation, and some transaction counter parties (e.g., lenders or other parties to a merger) may require representations or legal opinions about compliance with all laws that could be troublesome if its governing documents do not conform to TBOC, advisable to update governing documents to conform to TBOC, but entity will not cease to exist if charter not conformed.

Texas Business Organizations Code

- TBOC was amended in 2015 Legislative Session:
  - S.B. 860 by Sen. Kevin Eltife (*available at* http://www.capitol.state.tx.us/BillLookup/History.aspx?LegSess=84R&Bill=SB860) amended the TBOC to update its provisions relating to corporations, including *inter alia*,
    - replaces the statutory prohibition against a domestic entity's merger or conversion (and against a plan of exchange being effected) if it results in personal liability for an owner or member of that entity without the owner's or member's consent with a simple prohibition on the owner or member becoming subject to "<u>owner liability</u>" without the owner's or member's consent, and then defining "<u>owner liability</u>" as personal liability for a liability or other obligation of an entity that is imposed on a person by statute solely because of the person's status as an owner or member of the entity or by a governing document thereof under the TBOC or law of the entity's jurisdiction of formation;
    - provides that ownership interests are not required to be certificated to the extent a governing document of the entity or a resolution adopted by the entity's governing authority provides that some or all of the classes or series of the ownership interests are uncertificated or provides that some or all of each of the classes or series of the ownership interests are uncertificated and clarifying that an entity may have outstanding both certificated and uncertificated ownership interests of the same class or series;

Texas Business Organizations Code – cont’d

- requires a plan of merger to include, among other required information, the identification of any of the ownership or membership interests of an entity that is a party to the merger that are to remain outstanding rather than converted or exchanged if the entity survives the merger;
- authorizes any of the terms of a plan of merger, exchange, or conversion to be made dependent on facts ascertainable outside of the plan, as applicable, if the manner in which those facts will operate on the terms thereof is clearly and expressly stated in the plan;
- authorizes a plan of merger to include amendments and restatements of the governing documents of any surviving entity;

Texas Business Organizations Code – cont’d

- requires any limit on the term or duration of a corporation’s shareholders’ agreement to be set forth in the agreement, removes a provision establishing the validity of such a shareholders’ agreement for a period of 10 years, and establishes that a shareholders’ agreement that was in effect before September 1, 2015, remains in effect for 10 years, unless the agreement provides otherwise;
- authorizes the amount of the consideration to be received for shares to be determined by the Board, or plan of merger or conversion, as applicable, by means of approval of a formula to determine that amount;
- authorizes bylaws to require one or both of the following:
  - when soliciting proxies or consents with respect to an election of directors, the corporation include in both its proxy statement and any form of its proxy or consent one or more individuals nominated by a shareholder in addition to individuals nominated by the Board or
  - the corporation reimburse expenses incurred by a shareholder in soliciting proxies or consents with respect to an election of directors so long as the reimbursement requirement does not apply to any election for which the record date precedes that requirement’s adoption;

Texas Business Organizations Code – cont’d

- Based on DGCL § 251(h), amends TBOC § 21.459 to permit a plan of merger for a public company to contain provisions obviating need for a shareholder vote on the merger, after acquiring in a tender offer sufficient shares to approve the merger and provides dissenters rights in such a merger (see *Choice of Entity* paper pp 235-236);
- Based on DGCL §§ 204 and 205, adds TBOC §§ 21.901-21.917 providing statutory procedures to the ratification of defective corporate acts or shares, including establishes that a defective corporate act or putative shares is not void or voidable solely as a result of a failure of authorization if the act or shares are ratified in accordance with these TBOC provisions or validated by a district court (see *Choice of Entity* paper pp 304-305).

Texas Business Organizations Code – cont'd

- S.B. 859 by Sen. Kevin Eltife (*available at* http://www.capitol.state.tx.us/BillLookup/History.aspx?LegSess=84R&Bill=SB859) to update its provisions relating to partnerships and limited liability companies, including , *inter alia*,
  - to specify that an application for registration of an LLP accepted by the Secretary of State is considered to be an effective registration and conclusive evidence of the satisfaction of all conditions precedent to an effective LLP registration;
  - provides that an LLP registration is effective until it is withdrawn or terminated and repeals the annual renewal requirements;
  - establishes that an LLP registration, except in a proceeding by the State to terminate its registration, continues in effect so long as there has been substantial compliance with statutory provisions relating to the registration generally and with annual reporting requirements established by the bill's provisions, effective January 1, 2016;

Texas Business Organizations Code – cont'd

- requires an LLP that has an effective registration, not later than June 1 of each year following the calendar year in which the application for LLP registration takes effect, to file with the Secretary of State a report that contains the name of the LLP and the number of its partners as of the date of filing of the report;
- requires the Secretary of State, not later than March 31 of each year, to provide to each LLP that had an effective registration as of December 31 of the preceding year a written notice stating that the annual report and applicable filing fee are due on June 1 of that year and the registration of the LLP will be terminated unless the report is filed and the filing fee is paid on or before the date prescribed;
- requires the Secretary of State to impose a fee for filing the annual report in an amount equal to $200 for each partner on the date of filing the report;
- establishes that the registration of an LLP that fails to timely file an annual report or pay the required filing fee is automatically terminated;
- specifies that the termination of an LLP registration affects only the LLP's status as an LLP and is not an event requiring a winding up and termination of the partnership;
- authorizes an LLP whose registration was terminated for failure to file the annual report or pay the filing fee to apply to the Secretary of State for reinstatement of its LLP status not later than the third anniversary of the effective date of the termination;

Texas Business Organizations Code – cont’d

- for the purposes of LLC or partnership formation, internal affairs or termination, a power of attorney is irrevocable if the power of attorney is coupled with an interest sufficient in law to support an irrevocable power and the power of attorney states that it is irrevocable, and that the irrevocable power of attorney, unless otherwise provided in the power of attorney, is not affected by the subsequent death, disability, incapacity, winding up, dissolution, termination of existence, or bankruptcy of, or any other event concerning, the principal;
- excludes the term “majority-in-interest,” as defined in statutory provisions relating to supplemental provisions for domestic general partnerships, from a provision prohibiting a partnership agreement or the partners from waiving or modifying certain general provisions of the TBOC;
- creates an exception to the requirement that a general partner file a certificate of amendment reflecting a change in the address of the registered office or a change in the name or address of the registered agent of the limited partnership if the registered agent of a filing entity or foreign filing entity files the required statement of such change in accordance with statutory provisions related to the filing; and
- repeals a statutory provision limiting the applicability of statutory provisions relating to meetings of and voting by LLCs to the governing authority of an LLC.

Texas Business Organizations Code – cont'd

- S.B. 1077 by Sen. Kevin Eltife amends Section 1.201(b)(27) of the Texas Business & Commerce Code to expand the definition of "person" under the Uniform Commercial Code to include a particular series of a for-profit entity, although LLC series are defined in TBOC §101.622 as not being separate from their connected limited liability companies, although a series is authorized to function separately for certain purposes, *available at* http://www.capitol.state.tx.us/BillLookup/History.aspx?LegSess=84R&Bill=SB1077.
- Each of TBOC bills drafted by Codification Committee of Business Law Section, supported by Texas Business Law Foundation ("***TBLF***"), and will become effective September 1, 2015

Federal Income Taxes

[*Choice of Entity* paper Appendix A]

- "***<u>Check-the-Box</u>***" Regulations [*Choice of Entity* paper Appendix A pp 1-3]
- Corporations
  - Rates 15%-35%
  - Shareholders taxed on dividends at 20% plus 3.8% Unearned Income Medicare Contribution Tax ("***<u>net investment income tax</u>***") on the lesser of (1) the taxpayer's net investment income for the tax year or (2) the excess of modified adjusted gross income for the tax year over the threshold amount of $200,000 ($250,000 in the case of joint filers and surviving spouses, and $125,000 in the case of a married taxpayer filing separately)
- Partnerships and LLC
  - "Flow thru" entities with no entity level tax
  - Tax at owner level

Margin Tax
[*Choice of Entity* paper Appendix B]

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

Margin Tax – cont'd
[*Choice of Entity* paper Appendix B]

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

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

- Tax rate for 2015 applied to the Texas portion of the tax base is 0.975%.
  - Effective January 1, 2016, rate goes down to 0.75%.
  - Exception for retail and wholesale businesses which pay a 0.475% rate for 2015 and 0.375% for 2016.
- Margin Tax changes the calculus for entity selections, but not necessarily the result.
  - LLC has become more attractive as it can elect to be taxed as a corporation or partnership for federal income tax purposes. [*Choice of Entity* paper Appendix A pp 1-3; Appendix C]
  - Uncertainties as to an LLC's treatment for self employment purposes can restrict its desirability in some situations. [*Choice of Entity* paper Appendix A pp 15-17]

DECISION MATRIX
[*Choice of Entity* paper Appendix C]

- Key elements in deciding among business entities are:
  - How the entity will be taxed.
  - Who will be liable for its contract, tort and statutory obligations (entity itself will always be liable to the extent of its assets; question is whether owners will be liable if entity's assets insufficient to satisfy all claims).
- If the owners are content to pay federal income taxes at the entity level (15% to 35%) and then pay taxes on earnings distributed to them, the choice may be regular business corporation without an S-corporation election.
  - Comparable tax result may be achieved with LLC that elects to be taxed as C-corporation under IRS Check-the-Box Regulations.
  - LLC may be preferable because greater governance structuring flexibility.

DECISION MATRIX – cont'd
[*Choice of Entity* paper Appendix C]

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

DECISION MATRIX – cont'd
[*Choice of Entity* paper Appendix C]

- If the owners are willing to accept liability for their own torts but want to avoid liability for contracts and torts of other partners for which they have no culpability and are willing to pay the Margin Tax, the <u>LLP</u> may be the entity of choice.
  - Law firms typically organized as LLPs because not subject to old franchise tax when choice of entity decision made.
  - Margin Tax may change choice to PLLC as comparable liability shield, both LLP and PLLC can be partnerships for federal tax purposes but subject to Margin Tax, and PLLC not subject to $200 per partner per year fee payable to the Secretary of State.

DECISION MATRIX – cont'd
[*Choice of Entity* paper Appendix C]

- The limited partnership provides tax flow through without the S-corporation restrictions discussed below, with no self-employment tax on income of limited partners, and with limited liability for limited partners, but has its own limitations:
  - Must have a general partner which is liable for all partnership obligations — contract and tort — but under Check-the-Box Regulations, capitalization of general partner is not important (which allows use of nominally capitalized LLC as general partner) and a limited partnership can elect to also be an LLLP which has the effect of limiting the liability of the general partner.
  - Limited partners who participate in management of business may become liable as general partners, but statutes generally allow a degree of participation and no liability unless creditor relied upon the limited partner as a general partner.
  - Desirable for (i) family entities when some members want to retain control while spreading asset values among children or extended family and (ii) O&G and real estate syndications when flow through tax treatment important and promoters want to retain control with limited fiduciary duties.

DECISION MATRIX – cont'd
[*Choice of Entity* paper Appendix C]

- The <u>LLC</u> can be structured to have tax flow through and limited liability of S-corporation or limited partnership without any of the drawbacks for them, but:
  - Subject to the Margin Tax.
  - Self-employment tax issues (see *Choice of Entity* paper Appendix A pp 15-17).
  - Maximum governance flexibility as company agreement can define how entity will be managed and limit fiduciary duties and liabilities of managers.

DECISION MATRIX – cont'd

[*Choice of Entity* paper Appendix C]

- The S-corporation will give limitation of owner liability and federal income tax flow through (even when there is only one owner), but an S-corporation is subject to the Margin Tax, and under the Internal Revenue Code. S-corporation status is not available where the entity:
  - has more than 100 equity holders;
  - has more than one class of stock;
  - has among its shareholders any:
    - general or limited partnership
    - trust (certain exceptions)
    - non resident alien
    - corporation (exception for "qualified subchapter S subsidiary").

TAX COSTS IN CHOICE OF ENTITY DECISION
[*Choice of Entity* paper Appendix C p 5]

The following chart compares the taxes that would be paid by different types of entities and their individual owners based on assumed gross receipts, gross margin and net income in 2015. In each case, the entity is assumed to have (i) $1,000 of gross revenue, (ii) $700 of gross margin for Margin Tax purposes, which would be the maximum taxable margin under Tex. Tax Code § 171.101(a)(1) and all of which is apportioned to Texas under Tex. Tax Code § 171.101(a)(2), and (iii) $100 of net income that is of a type subject to self-employment taxes (i.e., is income from a trade or business and is not investment income) and is distributed (after taxes) to its owners. It is also assumed that the individual owners will have earned income or wages in excess of the base amount for the tax year and will therefore be subject to only a 2.9% (3.8% on individual self employment income in excess of $200,000 [$250,000 in the case of a joint return; $125,000 in the case of a married taxpayer filing separately]) Medicare tax on all self employment income (there is no ceiling), and not the 12.40% social security equivalent tax to a base of $118,500 in 2015.

Item	C-Corporation	S-Corp or Limited Liability Company [b]	General Partner in LLP or Limited Partnership [b]	Limited Partner in Limited Partnership [b]
Entity Level				
Total Revenue	1,000.00	1,000.00	1,000.00	1,000.00
Taxable Margin	700.00	700.00	700.00	700.00
Net Income	100.00	100.00	100.00	100.00
Margin Tax [c]	6.65	6.65	6.65	6.65
Taxable Income of Entity	93.35	93.35	93.35	93.35
Fed. Income Tax (at 35%)	32.67	0.00	0.00	0.00
Income After Taxes [d]	60.68	93.35	93.35	93.36
Owner Level				
Distribution & Share of Income	60.68	93.35	93.35	93.35
Self-Employment Tax	0.00	2.90[e]	2.90[e]	0.00
Taxable Income of Owner	60.68	91.90[f]	91.90[f]	93.35
Fed. Tax On Dividends (20%) or Income Allocation (39.6%)	12.14	36.39	36.39	36.97
Amount Received After Taxes	**48.54**	**55.51**	**55.51**	**56.38**

(a) Individuals are subject to a self-employment tax on self-employment income. For 2015 the tax rate aggregates up to 15.3% and consists of (i) a 12.40% social security equivalent tax on self-employment income up to a 2015 contribution base of $118,500 (adjusted annually for inflation), plus (ii) a 2.9% (3.8% on individual self-employment income in excess of $200,000 [$250,000 in the case of a joint return; $125,000 in the case of a married taxpayer filing separately]) tax for hospital insurance ("***Medicare***") on all self-employment income (there is no ceiling). This self-employment tax is treated as part of the income tax and must also be taken into account for purposes of the estimated tax. A similar addition to Medicare tax applies for FICA purposes. If the taxpayer has wages subject to FICA, then the taxpayer's social security equivalent wage base would be reduced by amount of wages on which these taxes were paid. There is no cap on self-employment income subject to the Medicare tax.

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

(c) Assumes that (i) Margin Tax is applicable since gross receipts are all in 2015, (ii) the gross margin for Margin Tax purposes is $700, which would be the maximum taxable margin under Tex. Tax Code § 171.101(a)(1), and all of it is apportioned to Texas under Tex. Tax Code § 171.101(a)(2), and (iii) the applicable Margin Tax rate is 0.95% (the rate is 0.475% for a narrowly defined group of retail and wholesale businesses). Under Tex. Tax Code § 171.101(a)(1) a taxable entity's taxable margin is the lesser of (x) 70% of its total revenue or (y) an amount determined by subtracting from its total revenue either its cost of goods sold or its compensation paid as elected or deemed elected pursuant to the Tex. Tax Code. *See* Appendix B. Assumes the business cannot take advantage of the $1,080,000 alternative minimum deduction effective for the 2015 report. Tex. Tax Code § 171.002.

(d) The income after taxes of most entities is the net income of the entity less the Margin Tax and, in the case of the C-corporation, the applicable federal income taxes.

(e) A non-managing member of an LLC may not be subject to the self-employment tax; a shareholder of an S-corporation is not subject to self-employment tax on his share of its income, but would be subject to employment tax on compensation received.

(f) Only one-half of the self-employment tax is deductible against the individual's income for federal income tax purposes.

(g) Does not take into account the 3.8% Unearned Income Medicare Contribution Tax on net investment income discussed on p. 3 of Appendix C of *Choice of Entity* paper under B.2 – 3.8% Unearned Income Medicare Contribution Tax.

GOVERNANCE FLEXIBILITY

- Partnerships and LLCs are creatures of contract and have greater governance structuring flexibility than corporations. [*Choice of Entity* paper pp 286-287; 294-296; 318-324]
- Corporations typically governed by directors who have fiduciary duties [*Choice of Entity* paper pp 53-178]:
  - Care
  - Loyalty
  - Candor

GOVERNANCE FLEXIBILITY – cont'd

- On June 20, 2014, the Texas Supreme Court issued its opinion in *Ritchie v. Rupe*, 443 S.W.3d 856 (Tex. 2014), holding that:
  - For claims of "minority shareholder oppression" – essentially, acts of a majority shareholder group that are harmful to a minority shareholder without necessarily harming the corporation itself – the sole remedy available under Texas law is a statutory receivership.
  - Common law fiduciary duties, as articulated in *Gearhart Indus., Inc. v. Smith Intern., Inc.*, 741 F.2d 707, 723-24 (5th Cir. 1984), are still the appropriate lens through which to evaluate the conduct of directors of Texas corporations.
  - *Gearhart* held that under Texas law "[t]hree broad duties stem from the fiduciary status of corporate directors; namely the duties of obedience, loyalty, and due care," and commented that (i) the duty of obedience requires a director to avoid committing *ultra vires* acts, i.e., acts beyond the scope of the authority of the corporation as defined by its articles of incorporation or the laws of the state of incorporation, (ii) the duty of loyalty dictates that a director must act in good faith and must not allow his personal interests to prevail over the interests of the corporation, and (iii) the duty of due care requires that a director must handle his corporate duties with such care as an ordinarily prudent man would use under similar circumstances.
  - The Gearhart decision stated a strong business judgment rule:
    - The business judgment rule is a defense to the duty of care. As such, the Texas business judgment rule precludes judicial interference with the business judgment of directors absent a showing of fraud or an *ultra vires* act. If such a showing is not made, then the good or bad faith of the directors is irrelevant.

GOVERNANCE FLEXIBILITY – cont'd

- On May 29, 2015, the Texas Supreme Court in *Sneed v. Webre*, 465 S.W.3d 169, 178 (Tex. 2015), which involved the application of the business judgment rule to a shareholder derivative suit on behalf of a closely held Texas corporation with fewer than 35 shareholders, held:
  - "The business judgment rule in Texas generally protects corporate officers and directors, who owe fiduciary duties to the corporation, from liability for acts that are within the honest exercise of their business judgment and discretion."
- Following *Ritchie v. Rupe* and *Gearhart*, the Texas Supreme Court in *Sneed v. Webre* cited and quoted from the 1889 Supreme Court opinion of *Cates v. Sparkman* as setting the standard for judicial intervention in cases involving duty of care issues:
  - In Texas, the business judgment rule protects corporate officers and directors from being held liable to the corporation for alleged breach of duties based on actions that are negligent, unwise, inexpedient, or imprudent if the actions were "within the exercise of their discretion and judgment in the development or prosecution of the enterprise in which their interests are involved." *Cates*, 11 S.W. at 849. "Directors, or those acting as directors, owe a fiduciary duty to the corporation in their directorial actions, and this duty 'includes the dedication of [their] uncorrupted business judgment for the sole benefit of the corporation.'" *Ritchie*, 443 S.W.3d at 868 (quoting *Int'l Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 577 (Tex. 1963)). The business judgment rule also applies to protect the board of directors' decision to pursue or forgo corporate causes of action.
- None of *Sneed v. Webre*, *Ritchie v. Rupe*, *Gearhart* nor the earlier Texas cases on which they relied referenced "gross negligence" as a standard for director liability. Earlier Federal District Court decisions in the context of lawsuits by the Federal Deposit Insurance Corporation and the Resolution Trust Company arising out of failed financial institutions held that the Texas business judgment rule does not protect "any breach of the duty of care that amounts to gross negligence" or "directors who abdicate their responsibilities and fail to exercise any judgment." These decisions, however, "appear to be the product of the special treatment banks may receive under Texas law" and likely will not be followed to hold directors "liable for gross negligence under Texas law as it exists now" in other businesses. *See Floyd v. Hefner*, C.A. No. H-03-5693, 2006 WL 2844245, at *28 (S.D. Tex. Sept. 29, 2006).

GOVERNANCE FLEXIBILITY – cont'd

- Personal liability for breach of fiduciary duties.
  - Statutes provide charter can provide some limitation of director liability:
    - Certificate of formation provisions limiting director liability for breach of the fiduciary duty of care, [*Choice of Entity* paper pp 66; 107-108]
    - Renounce business opportunities [*Choice of Entity* paper pp 63-64; 81-82]
    - Interested director transactions [*Choice of Entity* paper pp 61-62; 67-69]
  - Indemnification within limits and advancement of defense costs. **Beware of bylaw and indemnification provisions that require <u>*advancement*</u> of expenses to directors, officers and <u>*agents*</u> to the <u>*maximum extent permitted by law*</u>**; consider denying advancement of expenses where entity is plaintiff prior to change in control**.**
- Officers are agents and have fiduciary duties/liabilities comparable to directors; but charter cannot limit officers' liability.

GOVERNANCE FLEXIBILITY – cont'd

- LLCs and partnerships are "***alternative entities***".
  - Courts apply "contractarian" approach in measuring fiduciary duties of partners.
  - Fiduciary duties of general partners [*Choice of Entity* paper pp 290-291; 298-312; 325-346] are highest and include:
    - Care
    - Loyalty
    - Candor
  - Fiduciary duties of managers of LLC analogous to corporate directors absent contractual definition [*Choice of Entity* paper pp 325-346].
  - Texas LLC and partnership statutes allow modification of common law duties. Delaware allows partnership and LLC agreements to eliminate fiduciary duties. TBOC only allows restriction and 2013 amendment to TBOC allows limitation of governing person liability to the extent permitted for corporations (eliminate duty of care but not loyalty).

Owner Liability for Entity Obligations

- General partnership
  - Partners jointly and severally liable for partnership obligations, but after 2011 creditor must exhaust partnership assets before pursuing partners [*Choice of Entity* paper p 287-289].
- LLP
  - Partners not liable for contractual obligations of partnership or torts of other partners [*Choice of Entity* paper pp 375-378]. 2011 Legislation clarified that liability incurred when contract entered into or tort event occurred; eliminated liability for action of other partners supervised or involved in same activity; and deleted requirement of $100,000 of insurance.
- LP
  - General partner liable for all partnership obligations (unless LLLP) (could have LLC with nominal assets), but limited partners not liable for partnership obligations unless participate in management of business and creditor relied upon limited partner as a general partner [*Choice of Entity* paper pp 296-297].

Owner Liability for Entity Obligations – cont'd

- Corporation [*Choice of Entity* paper pp 49-52]
  - Shareholders generally not liable for entity obligations.
  - "Pierce the corporate veil".
    - *Castleberry v. Branscum* (Tex 1986).
    - TBCA art. 2.21/TBOC § 21.223:
      - No liability for contracts unless alter ego or fraud.
      - No piercing for contract or tort for failure to comply with TBOC, corporate governing documents or corporate formalities.
    - *SSP Partners* (Tex. 2008) [*Choice of Entity* paper pp 51-52]: rejects single enterprise veil piercing theory and applies TBCA art. 2.21 to tort case]

Owner Liability for Entity Obligations – cont'd

- LLC [*Choice of Entity* paper pp 349-354]
  - Legislative history:
    - Article 4.03. Liability to Third Parties. This Article provides except as provided in the regulations, that a member or manager is not liable to third parties, expresses the legislative intent that limited liability be recognized in other jurisdictions and states a member is not a proper party to a proceeding by or against a Limited Liability Company. [*Choice of Entity* paper pp 349-350 at note 1382]
  - Some cases suggest corporate veil piercing concepts apply to LLCs [*Choice of Entity* paper pp 350-352 at note 1384]. TBOC §101.002 amended in 2011 to provide TBOC veil piercing limitations for corporations also apply to LLCs if veil piercing permitted.

State of Incorporation

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

State of Incorporation – cont'd

- Partnership and LLC Agreements Respected
  - Unlike TBOC, Delaware statutes governing partnerships and LLCs provide that their policy is to give maximum effect to the principle of freedom of contract and to entity agreements and allow the elimination of fiduciary duties (but not the contractual duty of good faith and fair dealing) [*Choice of Entity* paper pp 304-312; 330-346].
  - Judicial application of these principles illustrated by six recent cases discussed in *Choice of Entity* paper pp 307-312 involving limited partnership reorganizations in which the general partner or an affiliate was the survivor or acquiring party. In four of them, the Delaware Supreme Court affirmed the elimination of common law fiduciary duties and their replacement with a provision authorizing related party transactions if a conflicts committee of independent directors in good faith determines that the transactions are in the best interests of the partnership. The fifth decision applied the implied covenant of good faith and fair dealing (which cannot be eliminated) and held that a fairness opinion was inadequate to support a transaction with the GP because it only covered the fairness of the entire transaction rather than to the LPs.
  - In the sixth decision Vice Chancellor Laster in *El Paso Pipeline Partners, L.P. Derivative Litigation* on April 20, 2015 awarded $171 million to the plaintiff limited partners because it found that the conflicts committee of the Board of the general partner did not in fact believe in good faith that the transaction was in the best interests of the partnership because its analysis focused on whether the purchase would enable the partnership to increase its distributions rather than whether it was paying too much for the assets. In a 60 page opinion the Court found that the testimony of the committee members that they had a good faith belief that the transaction was in the best interests of the partnership was not credible because their emails and other objective evidence showed that they were simply going through the motions to approve a transaction they knew general partner wanted and never considered saying no. The Court also focused on the conclusionary nature of the information provided and second guessed the analysis of the committee's financial advisor.

State of Incorporation – cont'd

- Respect for Stockholder Voting Rights
  - Lenders frequently insist that their credit agreements give them the right to accelerate the loans if there is a change in control of the borrower.
  - In *Amylin* case [*Choice of Entity* paper pp 263-264] an indenture provision permitted acceleration of the notes if directors approved by prior Board ceased to comprise a majority of the directors was challenged in the course of a proxy contest and the Court in essence held that the existing Board could and should approve the insurgent's slate in order to avoid a default even through it was opposing them in the proxy contest. Plaintiff argued Board violated its duty of care by not focusing on the change in control provision when approving the indenture and, in approving a settlement in which plaintiff's counsel was awarded a $2.9 million fee, the Court criticized borrower's counsel for not focusing the Board on the change in control provision.
  - In *Pontiac General Employees Retirement System v. Ballantine* (known as the *Healthways* case) [*Choice of Entity* paper pp 264-265] a loan agreement was entered into in the context of a contested election which contained an acceleration right triggered by a new Board majority within a 24-month look back period (called a "dead hand proxy put"). Plaintiff sued for a declaratory judgment that the proxy put was unenforceable because the Board breached its fiduciary duties by approving the provision and the bank for aiding and abetting their violation. The Vice Chancellor Laster denied defendants motion to dismiss and as settlement in the case was approved on May 8, 2015 in which the provision was amended out of the credit agreement and the plaintiff's lawyer received a $1.2 million fee.

State of Incorporation – cont’d

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

Business Entity Acquisition Decision Tree

[*Acquisition Structure* paper]

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

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

Alternative Structures for Acquisitions of Businesses – cont'd

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

Alternative Structures for Acquisitions of Businesses – cont'd

- **Divisive merger – under TBOC § § 1.002(55)(A) and 10.001-10.008, an entity can merge itself creating two or more surviving entities (plan of merger can divide assets and liabilities among parties, but limited prejudice to rights of existing creditors)**
- TBOC § 10.008(a) provides when a merger takes effect upon the filing of a certificate of merger with the Secretary of State, the separate existence of the constituent entities ceases, and all assets and liabilities of the constituent entities are vested in the surviving entity without "any transfer or assignment having occurred." This means that all assets of constituent entities move in accordance with the plan of merger, <u>but</u> under TBOC a merger is <u>not</u> an "<u>***assignment***</u>" for purposes of provisions in contracts prohibiting assignment <u>unless</u> (1) the contract is an IP license (see *Cincom Systems, Inc. v. Novelis Corp.*, 581 F.3d 431 (6th Cir. 1009) discussed in note 15 on p 10 of *Acquisition Structure* paper in Chapter 1.2) or (2) the contract provides that a merger is deemed to be an assignment or otherwise prohibits the merger. See note 3 on page 9 of *Acquisition Structure* paper for Delaware *Mezo Scale* holding that reverse triangular merger is not an assignment under certain contract provisions.

Alternative Structures for Acquisitions of Businesses – cont'd

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

Alternative Structures for Acquisitions of Businesses – cont'd

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

Alternative Structures for Acquisitions of Businesses – cont'd

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

Alternative Structures for Acquisitions of Businesses – cont’d

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

Alternative Structures for Acquisitions of Businesses – cont'd

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

Alternative Structures for Acquisitions of Businesses – cont'd

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

Alternative Structures for Acquisitions of Businesses – cont'd

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

Alternative Structures for Acquisitions of Businesses – cont'd

- Entire Agreement/Contractual Limitation of Extra contractual Liabilities [*Acquisition Structure* paper pp 296-316]
  - **Section 13.7 Entire Agreement, Non-reliance, Exclusive Remedies and Modification**

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

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

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

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

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

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

Alternative Structures for Acquisitions of Businesses – cont'd

- – *ABRY Partners V, L.P. v. F&W Acquisition LLC*, 891 A.3d 1032 (Del. Ch. 2006) (stock purchase agreement non-reliance clause that the buyer was not relying upon any representations and warranties not stated in the contract generally enforceable when the product of give-and-take between commercial parties who had the ability to walk away freely).
- – *RAA Management, LLC v. Savage Sports Holdings, Inc.*, 45 A.3d 107 (Del. 2012) (non-reliance disclaimer language in a confidentiality agreement was effective to bar fraud claims by a prospective buyer).
- – *Italian Cowboy Partners, Ltd. v. Prudential Ins. Co. of America*, 341 S.W.3d 323 (Tex. 2011), (pure merger clauses, without an expressed clear and unequivocal intent to disclaim reliance or waive claims for fraudulent inducement, do not defeat claim for fraudulent inducement).
- – *Allen v. Devon Energy Holdings, L.L.C. F/K/A Chief Holdings, L.L.C. and Trevor Rees-Jones*, 367 S.W.3d 355 (Tx. Ct. App. First Dist. March 9, 2012 No. 01-09-00643-CV) (case settled in 2013) (in the context of allegations by seller that CEO and majority owner fraudulently induced seller to sell and citing *Abry* and *Italian Cowboy*, held that disclaimer and release provisions relating to the value of the company did not negate reliance or materiality as a matter of law, as omissions related to seller's decision whether to sell rather than value of company; fact issue existed as to fraud and the existence of a fiduciary relationship).
- – *Staton Holdings, Inc. v. Tatum, LLC*, 345 S.W.3d 729 (Tx. App.-Dallas 2011) (express negligence doctrine applies to non-reliance clauses).

Alternative Structures for Acquisitions of Businesses – cont'd

- Confidentiality
  - A confidentiality agreement is the first stage for the due diligence process as parties generally are reluctant to provide confidential information to the other side without having the protection of a confidentiality agreement.
  - The target typically proposes its form of confidentiality agreement, and a negotiation of confidentiality agreement ensues.
  - A seller's form of confidentiality agreement is attached as Appendix B to *Acquisition Structure* paper. Covenants in confidentiality agreements are enforceable and misuse of confidential information can lead to sanctions. See *Martin Marietta Materials, Inc. v. Vulcan Materials Co.*, 68 A.3d 1208 (Del. 2012) (hostile tender offer enjoined because bidder misused information received under confidentiality agreement entered into during aborted negotiations for friendly deal). See *Fiduciary Duty* paper pp 278-280.
  - In asset purchase, confidential information is part of assets purchased and buyer/seller will need to modify confidentiality agreement. See pp 271-284 of *Acquisition Structure* paper.

Alternative Structures for Acquisitions of Businesses – cont'd

- Letters of Intent
  - Buyer may seek letter of intent that is generally not binding on either party (exceptions for expenses, confidentiality, good faith negotiation, etc.). The right words are critical in determining extent to which a letter of intent is non binding. See *Global Asset Capital, LLC v. Rubicon*, C.A. No. 5071-VCL (Del. Ch. 2009) discussed in note 10 on pp 8-9 of Exhibit C to *Acquisition Structure* paper.
  - Even if the letter of intent has unambiguous words to the effect that no binding contract will exist until a definitive agreement is signed, the conduct of the parties (particularly press releases and joint marketing efforts) can lead a trier of fact to find that the parties have entered into a definitive agreement. *Energy Transfer Partners, L.P. ("__ETP__") vs. Enterprise Product Partners, L.P. ("__Enterprise__"*) involved an action over an aborted joint venture. ETP claimed it had formed a joint venture with Enterprise to build an oil pipeline, and that Enterprise wrongfully terminated it. ETP and Enterprise had signed preliminary agreements which provided that there would be no partnership or joint venture formed unless and until definitive agreements were executed. Although no definitive joint venture agreement had been signed, the parties proceeded to spend time and money on the project and, reminiscent of *Texaco v. Pennzoil*, they communicated publicly that a joint venture had been formed and they marketed the pipeline to potential customers as if they had formed a joint venture. Notwithstanding the express provisions in preliminary agreements that nobody was bound unless and until definitive agreements were signed, ETP claimed, and the jury found, that the parties' ensuing conduct served to form a Texas law partnership and that Enterprise breached its fiduciary duty of loyalty to ETP by taking the project to a competitor. The jury awarded $319 million plus attorneys fees to ETP.
  - If a letter of intent has been executed that includes a no-shop provision and gives the buyer adequate opportunity to conduct due diligence, the buyer may resist becoming contractually bound until it is ready to close; conversely, the seller has an interest in not permitting extensive due diligence until the buyer is contractually bound.
  - A form of letter of intent is attached as Exhibit C to *Acquisition Structure* paper.

Joint Venture As Form of Acquisition

- Joint venture is relationship typically between two or three entities to accomplish a defined objective, and may take form of a contract or an entity. *Joint Venture* paper pp 1-2.
  - Traditionally, joint venture was thought of as limited purpose general partnership—but today more likely an LLC. *Joint Venture* paper pp 5-9.
  - Contributions to joint venture can range from an established business unit with people and knowledge to cash or a license of IP (perhaps technology which one party has and needs funds and marketing muscle of other to develop; could be two parents putting together under-performing units to generally get off balance sheet).
  - Expectations range from development of a product or project to a stand alone business where exit strategy is IPO or sale of joint venture. Exit strategy could also be dissolution of joint venture and distribution to partners.

Joint Venture As Form of Acquisition – cont'd

- Joint venture may be contract relationship or entity.
- LLC in US is now entity of choice for joint ventures (principally limited liability with flexibility to be taxed as corporation or partnership and ability to limit fiduciary duties).
- *Dernick Resources Inc. v. Wilstein*, 312 S.W.3d 864 (Tex. App.—Houston [1st Dist.] 2009, no pet.), [discussed in note 110 on p 19 of *Choice of Entity* paper] illustrates dangers of using term "joint venture" in contractual arrangements. Joint Venture paper p 2 at Note 7.

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