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SLAYING ZOMBIES IN THE COURTROOM: TEXAS ENACTS THE FIRST LAW DESIGNED SPECIFICALLY TO COMBAT BOTNETS

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I. INTRODUCTION

The Internet has become indispensable for companies and individuals, with billions of dollars of business being transacted on a daily basis. Indeed, children of high school age have never known a time without ready access to the Internet.[1] Thus, the Internet has achieved the status of a basic utility. However, unlike previous utilities (*e.g.*, the power grid, the telephone, etc.), the Internet is still largely unregulated. Consequently, the potential for misuse exists, and it should be no surprise that criminals and tortfeasors have found ways to exploit the Internet. One of the more virulent maladies plaguing the Internet today is botnets.

II. WHAT IS A BOTNET?

A botnet is a network of compromised Internet-connected computers that are not owned by the tortfeasor, but are used by the tortfeasor for his personal gain.[2] By using the processing power and network bandwidth of others, the tortfeasor relieves himself of the need to purchase his own computer equipment. Use of other's computers—without their permission—also makes it easier for the tortfeasor to pin the blame for his activities on innocent people. Use of the victim's computer may be only part of the problem. Depending upon the activity committed by the tortfeasor, the user's data present on the computer may also be copied or used in a prohibited activity.

The compromised computers, called "bots" or "zombies," are standard personal computers, typically running Microsoft's Windows operating system with sufficient disk space and high-speed Internet access so that the bot can perform activities such as sending SPAM, participating in distributed denial-of-service attacks, and committing identity theft.

Botnets are created and/or utilized by people called "herders". In order to obtain a botnet, the herder either must infect a set of Internet-connected devices or take over an existing botnet. While the preferred device is a personal computer ("PC"), in the future herders may begin infecting other Internet-capable devices, such as iPhones.[3]

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[1] *See generally*, Dan Tapscott, GROWING UP DIGITAL: THE RISE OF THE NET GENERATION (McGraw-Hill, 1997).

[2] "Compromised" is a computer security term of art for a machine whose security has been pierced so that it will obey the commands of an unauthorized person. The mainstream slang equivalent to "compromised" is "hacked," although the more precise term used by computer programmers and security specialists is "cracked." A cracker is defined as "[o]ne who breaks security on a system. Coine by hackers in defense against journalistic misuse of 'hacker'". Eric S. Raymond, THE NEW HACKER DICTIONARY 130 (3rd ed. MIT Press 1996).

[3] At the July 29, 2009 Black Hat Conference, security researcher Charlie Miller demonstrated how an attacker could take complete control of a victim's iPhone simply by sending special SMS control messages—which are different than your everyday SMS text message—to the person's device. The attack is enabled by a serious memory corruption bug in the way the iPhone handles SMS messages and effectively allows an attacker to make calls, steal data, send text messages, and do more or less anything a person can do on their iPhone. Android-based phones and Windows Mobile devices are also vulnerable to the same exploit. For more details, *see* Andy Greenberg, *Hacking the iPhone*, (August 4, 2009), http://www.forbes.com/2007/08/04/iphone-apple-mac-tech-cx_ag_0804miller.html. Incidentally, Apple has released a patch to remedy the vulnerability in its iPhone devices. Still, this exploit demonstrates the vulnerability of the devices, and the steps users will have to take in order to mitigate that vulnerability.

According to the software security firm McAfee, "[m]ore than 14 million computers have been enslaved by cybercriminal botnets, a 16 percent increase over last quarter's rise."[4] Not long ago, Vint Cerf estimated that up to one quarter of the computers connected to the Internet were part of one of many botnets.[5] One of the principal uses of botnets is to send unsolicited e-mail messages ("spam").[6] Other botnet-related maladies include extortion and identity theft.[7]

III. ZOMBIFICATION—CREATING THE BOTNET

To create a zombie, the herder relies on one or more modus operandi through which to transmit his bot software to the computer that is to be compromised.[8] Although normally done in a random fashion, specific sets of computers can be singled out for compromise. For example, the herder may add a set of software instructions to a website so that a user downloads the bot software simply by visiting the site; a process called "drive-by download".[9] The tortfeasor would then be relying on the website's content to attract a group of users who

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[4] Ally Zwahlen & Sean Brooks, *McAfee Q2 Threats Report Reveals Spam, Botnets at an All Time High (*July 29, 2009), http://newsroom.mcafee.com/article_display.cfm?article_id=3545.

[5] Tim Weber, *Criminals 'may overwhelm the web'*, BBC NEWS (Jan. 25, 2007), http://news.bbc.co.uk/2/hi/business/6298641.stm.

[6] Even as early as 2008, botnets were responsible for sending the majority of spam. *See, e.g.,* Joe Stewart, *Top Spam Botnets Exposed*, SECUREWORKS (April 8, 2008), http://www.secureworks.com/research/threats/topbotnets. ("Collectively, the top botnets are capable of sending 100 billion spams per day.") For an estimate on the costs of spam, *see, e.g.,* Robert McMillan, *How much does spam cost you? Google will calculate,* INFOWORLD (Nov. 19, 2008), http://www.infoworld.com/d/security-central/how-much-does-spam-cost-you-google-will-calculate-932. (Google Message Security calculator determines how many days and dollars your company loses in productivity to spam.).

[7] The extortion is accomplished through a "distributed denial of service" ("DDoS") attack. A DDoS attack is launched by a herder of the botnet by instructing the bots of his botnet to simply use the victim's server. For example, the herder can instruct the bots to ask for the home page of the victim's website. For each request made by the bot, the victim's server can service one fewer legitimate customer. Through the use of large numbers of bots, the herder can overwhelm the victim's server with meaningless requests and thereby deny that service and effectively take the victim's service off the Internet. Typically, the DDoS attack will commence for a short period of time, with a follow-up email going from the herder to the victim's information technology ("IT") department, asking the latter for money in order to preclude a resumption of the attack. *See, e.g.,* Cisco Systems, *Strategies to Protect Against Distributed Denial of Service (DDoS) Attacks*, http://www.cisco.com/application/pdf/paws/13634/newsflash.pdf. Identity theft is most often accomplished through the use of a "keylogger." A keylogger is a piece of software that records the keystrokes (and sometimes mouse motions) of a user in order to obtain passwords or other information that can be use to steal the victim's identity so that the herder can open new credit card accounts, or access existing bank accounts. In other cases, the herder is simply after existing credit card information so that he may make small transactions on those credit cards. By keeping the transactions small, the herder hopes to evade detection. However, because of the size of the botnet, the aggregate number of transactions using the information provided by the large number of bots can yield substantial benefits for the herder. *See, e.g.*, *Ilomo/Clampi botnet active in identity theft, steals bank website logins*, MXLOGIC VIRUSES/WORMS NEWS (August 25, 2009), http://www.mxlogic.com/securitynews/viruses-worms/ilomoclampi-botnet-active-in-identity-theft-steals-bank-website-logins482.cfm.

[8] "Bot software" means a software application that enables the computer to connect to the command and control infrastructure of the botnet and to perform the commands of the herder. There are many different bot software applications. Some of the more famous bot software applications are: "Conflicker," "Kraken," "Srizbi," and "Storm."

[9] *See, e.g., The Dirtiest Web Sites: Summer 2009,* http://safeweb.norton.com/dirtysites, where Symantec ranked the top 100 web sites that are infected with malware.

conform to a particular demographic profile. Another modus operandi involves releasing viruses or worms onto the Internet that infect machines in seemingly random patterns.[10] Once infected, the bot software is installed on the computer. The bot software itself can be in the form of a "rootkit," "keylogger" or other malevolent software that "cloaks" its presence in a manner that evades detection by the user and anti-virus software.[11] The bot software then attempts to make itself known to the herder in a pre-defined manner, either by contacting a "command and control server" directly, or through a peer-to-peer network.[12] Once contact is established, the zombie is available to perform the commands issued by the herder.

IV. OTHER CURRENT COMPUTER MISUSE STATUTES

While having related subject matter, Senate Bill 28 ("S.B. 28") is different from other computer security legislation. For instance, the CAN-SPAM Act focuses on the content of the spam message.[13] In contrast, S.B. 28 focuses on the method of transmission, rather than the content of the message. In this sense, S.B. 28 is content-neutral, and thus should escape the preemption clause in the CAN-SPAM Act.

There are many laws against computer crime and spyware, most notably the federal Computer Fraud and Abuse Act.[14] However, a substantial number of the computer crime laws covering the same subject matters as S.B. 28, focus on "access" and "authorization" of the user's device.[15] While the access and authorization statutes and case law are applicable to the creation and, in some cases, the function of the zombie PC, S.B. 28 is distinguishable because it also encompasses the acts of the herder or the renter, apart from the act of access and

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[10] A virus is a "self-propagating program that infects and may damage another program." IBM DICTIONARY OF COMPUTING 737 (10th ed.1994). A worm is "a program that places copies of itself into connected systems and that may do damage or waste resources". *Id*. at 749.

[11] A rootkit is a set of modified system libraries or executable programs that provide herders with hidden backdoors that allow them future access to a PC that they have compromised. Warran G. Kruse II & Jay G. Heiser, COMPUTER FORENSICS: INCIDENT RESPONSE ESSENTIALS 127 (2002). "A keylogger is a program that records the keystrokes on a computer." TechTerms.com definition for "keylogger," TECH TERMS COMPUTER DICTIONARY, *available at* http://www.techterms.com/definition/keylogger (last updated Feb. 22, 2008). In some cases, the malicious software will disable the PC's anti-virus software, leaving the PC vulnerable to additional attacks.

[12] *See, e.g.*, Gunter Ollmann, *Botnet Communication Topologies*, http://www.damballa.com/downloads/r_pubs/WP Botnet Communications Primer (2009-06-04).pdf (last visited June 10, 2009).

[13] The Controlling the Assault of Non-Solicited Pornography and Marketing (CAN-SPAM) Act of 2003, Pub. L. No. 108-187, 15 U.S.C. 7701 et seq. (2003).

[14] Spyware is a form of malware that records and then transmits information gathered from the compromised machine. For a summary of state anti-spyware statutes, *see* Benjamin Edelman, *State Spyware Legislation*, http://www.benedelman.org/spyware/legislation/ (last updated June 15, 2008). *See also,* Susan W. Brenner, *State Cybercrime Legislation in the United States of America: A Survey*, 7 Rich. J.L. & Tech. 28 (2001), *available at* http://jolt.richmond.edu/v7i3/article2.html; *See generally*, A. Hugh Scott, Computer and Intellectual Property Crime: Federal and State Law (2001). The Computer Fraud and Abuse Act, 18 U.S.C. 1030 et seq. (2006). Other federal computer crime legislation includes the Wire Fraud statute, 18 U.S.C. §1343 (2006) which was central to the issue in United States v. Seidlitz, 589 F.2d 152 (4th Cir. 1978); State v. McGraw, 480 N.E.2d 552 (Ind. 1985) (defendant convicted of "unauthorized control over the property [a computer] of the City of Indianapolis" under an Indiana law).

[15] *See* Orin S. Kerr, *Cybercrime's Scope: Interpreting "Access" and "Authorization" in Computer Misuse Statutes,* 78 N.Y.U. L. Rev. 1596, 1615-16 (2003).

authorization on the compromised machine. The reason that S.B. 28 differs in this respect is the not because the other laws lack teeth but because they lack incentive.

Little has been done to combat botnets because of the character of the existing computer crime laws that focus on the activities of individual machines. While the owner of a zombified computer may be afforded some relief under the Computer Fraud and Abuse Act or any number of state anti-spyware statutes, the individual victim has little incentive to seek such relief. Because of the nature of the intrusion, the individual's damages are limited; in many cases, the potential damages are far less than the potential cost of litigation. The limitations for an individual's damages are even more acute in the case of botnets, where the bot software cloaks itself or otherwise makes itself unknowable, and unobtrusive, to the owner of the compromised computer. Herders rely on the individual's lack of incentive to find and remove the bot software or otherwise interrupt the herder's activities.

Governments also lack the incentives to combat botnets. While their citizens are harmed, the priorities are such that the scarce resources afforded to attorney generals ("AG") are most often directed toward other activities that yield a "better bang for the buck." The direction of resources away from anti-botnet activities is understandable. Consider what the AGs would need to do in order to combat a botnet under the rubric of the previous computer crime laws. The AGs would have to focus on the individual bots and work up their cases according to the unauthorized access or unauthorized use of the particular compromised computers belonging to individuals. However, because botnets are creatures of computer networks, one must monitor the network in order to discern the traffic making up the botnet's activities and identify the individual zombies. Consequently, the AGs would first have to subpoena the Internet service providers ("ISPs"), because the users' ISPs would be in the best position to monitor the traffic that could identify both the botnet and the individual zombies within the ISP's own network. Once identified, the individual citizens would need to be contacted and their machines would need to be examined in order to gather the requisite evidence. All of that takes time and money, not to mention the disruption incurred by the individual. Consequently, the various AGs have done little to nothing to combat botnets.

ISPs also lacked the incentives necessary to combat botnets under previous computer misuse statutes. As with the AGs, the ISPs would have to take it upon themselves to monitor their networks for botnet traffic; although many of them do so anyway.[16] However, the ISPs could not recover damages under the previous computer misuse statutes on behalf of their customers and thus had no direct incentive to combat the botnets, particularly when some states preclude class action lawsuits of this kind. Notice, however, that the ISPs are central to the botnet equation because it is through their networks that the botnets operate. Consequently, any meaningful policy to combat botnets requires the support and cooperation of the ISPs.

S.B. 28 was designed to avoid the shortcomings of previous computer misuse laws by providing incentives directly to ISPs in order to solicit their cooperation in combating botnets. By expressly including ISPs as one of the potential plaintiffs, the aggregate harm caused by

[16] Security professionals have formed non-profit organizations, such as ShadowServer, to report and monitor botnet activities. *See* SHADOWSERVER, http://www.shadowserver.org/wiki/ (last visited Oct. 22, 2010).

hundreds—if not thousands—of zombies on the ISPs network could be addressed by an ISP. The damages afforded by S.B. 28 provide enough incentive to the ISP to undertake the legal action necessary to combat botnets.

V. A SHORT DESCRIPTION OF THE FIRST ANTI-BOTNET STATUTE

On September 1, 2009, S.B. 28, the first law tailored specifically to combat botnets, went into effect and was passed by the Texas Legislature during the previous legislative session.[17] A copy of S.B. 28 is provided in Appendix A.

S.B. 28 amended various portions of section 324 of the Texas Business & Commerce Code. Definitions were provided for "botnet" and "zombie."[18] A specific set of organizations was excluded from application of S.B. 28, namely ISPs, legitimate computer software providers, and computer security companies.[19] In order to encourage companies to combat the botnet problem, substantial penalties, including statutory damages of $100,000 per zombie, were also provided.[20] However, the list of plaintiffs was limited to victims who suffered a disruption of their business activities and ISPs on whose networks the effects of the violations were transmitted.[21]

S.B. 28 delineates a set of prohibited activities for the zombie or the botnet, namely:

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[17] Legislative Session 81(R). The bill was sponsored by Senator Zaffarini and Representative Deshotel. Tex. S.B. 28, Leg., 81st Sess. (Tex. 2009). For details about the progression of the bill, *see* Texas Legislature Online, http://www.capitol.state.tx.us, (locate "bill number" search bar; then enter "SB 28").

[18] A botnet is defined as a "collection of two or more zombies." TEX. BUS. & COM. CODE § 324.002(1-a) (Vernon 2009). A zombie is defined as a "computer that, without the knowledge and consent of the computer's owner or operator, has been compromised to give access or control to a program or person other than the computer's owner or operator." *Id.* § 324.002(9).

[19] Section 324.052 already had a list of exempted parties, and S.B. 28 merely added itself to that list. TEX. BUS. & COM. CODE § 324.052 (Vernon 2009); Tex. S.B. 28, Leg., 81st Sess. (Tex. 2009). The exempted organizations include: telecommunications carriers, cable operators, computer hardware or software providers, providers of information services or interactive computer services that monitor or have interaction with a subscriber's Internet or other network connection; or provider of services for network or computer security, diagnostics, updating/maintenance, remote system management, or detection of unauthorized use or illegal activity.

[20] Under section 324.055(f), the person bringing the action "may, for each violation: (1) seek injunctive relief to restrain a violator from continuing the violation;…(2) the greater of actual damages arising from the violation; or $100,000 for each zombie used to commit the violation;" or (3) both of the above. TEX. BUS. & COM. CODE § 324.055(f) (Vernon 2009). Subsection (g) allows the court to impose triple "damages if the court finds that the violations have occurred with such a frequency as to constitute a pattern or practice." *Id.* § 324.055(g). Subsection (h) allows a prevailing plaintiff to recover "reasonable attorney's fees," expert's fees, and court costs. *Id.* § 324.055(h). Subsection (i) states that these penalties are "not exclusive but [are] in addition to any other procedure or remedy provided for by other statutory or common law." *Id.* § 324.055(i).

[21] Section 324.055(e) designates who may "bring a civil action against a person who violates this section:" namely ISPs, *id.* at § 324.055(e)(1), and "a person who has incurred a loss or disruption of the conduct of the person's business...." TEX. BUS. & COM. CODE § 324.055(e)(2) (Vernon 2009). Section 324.055(a)(1) defines "Internet service provider" broadly as "a person providing connectivity to the Internet or another wide area network," and under section 324.055(a)(2), a "person" has the same meaning as section 311.005 of the Texas Government Code. TEX. BUS. & COM. CODE § 324.055(a)(1-2) (Vernon 2009); TEX. GOV'T. CODE § 311.005 (Vernon 2005).

- sending spam;[22]
- participating in a denial of service attack;[23]
- committing theft of intellectual property;[24]
- sending something from one zombie to make more zombies;[25]
- gathering information used to commit identity theft;[26] or
- "perform an act for another purpose not authorized by the owner or operator of the computer."

There is a second set of prohibited activities. This set of prohibited activities involves acts performed directly by the herder or the person who rents the botnet from the herder ("renter"), namely:

- a person may rent or gain control of another botnet, or
- sell or provide access to or use of your own botnet.[27]

This second set of prohibited activities was targeted specifically at herders who rent their botnets to spammers. As mentioned previously, spamming is one of the primary activities of a botnet, and one of the most pernicious and expensive problems plaguing Texas

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[22] Section 324.055(c)(1), specifically, "send an unsolicited commercial electronic mail message as defined by section 321.001." TEX. BUS. & COM. CODE § 324.055(C)(1) (Vernon 2009); TEX. BUS. & COM. CODE § 321.001 (Vernon 2009).

[23] Section 324.055(c)(2), specifically, "send a signal to a computer system or network that causes a loss of service to users." TEX. BUS. & COM. CODE § 324.055(c)(2) (Vernon 2009).

[24] Section 324.055(c)(3), specifically, "send data from a computer without authorization by the owner or operator of the computer." *Id.* § 324.055(c)(3). Data was not defined in the statute. The online Merriam-Webster dictionary defines "data" as: "factual information (as measurements or statistics) used as a basis for reasoning, discussion, or calculation" and "information in numerical form that can be digitally transmitted or processed." MERRIAM-WEBSTER, http://www.merriam-webster.com, (locate "Dictionary" tab; then search for "data"). The "numerical form" of the information may be the binary bits that represent the information. Assuming the latter meaning from the dictionary, then "data" would mean something like a file on a computer system.

[25] Section 324.055(c)(4), specifically, "forward computer software designed to damage or disrupt another computer or system," which is broad enough to encompass not just bot software, but other malware such as viruses, trojans, rootkits and, perhaps, adware. TEX. BUS. & COM. CODE § 324.055(c)(4).

[26] Section 324.055(c)(5), specifically, "collect personally identifiable information." *Id.* § 324.055(c)(5). Personally identifiable information is defined elsewhere within the Section as "an individual's first name or initial and last name in combination with any one or more of the following items: (A) date of birth; (B) social security number or other government-issued identification number; (C) mother's maiden name; (D) unique biometric data, including the individual's fingerprint, voice print, and retina or iris image; (E) unique electronic identification number, address or routing code; (F) telecommunications access device, including debit and credit card information; or (G) financial institution account number or any other financial information."

[27] Section 324.055(d) states that a person may not "(1) purchase, rent, or otherwise gain control of a zombie or botnet created by another person; or (2) sell, lease, offer for sale or lease, or otherwise provide to another person access to or use of a zombie or botnet." *Id.* § 324.055(d).

businesses.

VI. UTILIZING S.B. 28—THE CAUSE OF ACTION

A cause of action under S.B. 28 requires four elements:[28]

1. At least one bot (zombie);

2. A botnet, to which the bot is a part;

3. One of the prohibited activities performed by the botnet *or* a zombie; and

4. A perpetrator (such as the herder or the person who rents the botnet from the herder).

Obtaining jurisdiction should not be a problem because Texas has long arm jurisdiction.[29] All that need take place is for part of the botnet (i.e., some of the zombies) to lie within Texas, or the harm to the victim be felt in Texas. Statistically speaking, since Texas has about 9% of all PC's in the U.S., and most botnets are composed (on average) of 20,000 zombies, at any given time the average botnet has 1,800 zombies within Texas borders.[30] While it is not likely that a court will accommodate "jurisdiction by statistics," it is suggested that once the command and control server is found, it should be a technologically, simple matter to identify some of the hundreds of bots within Texas.

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[28] S.B. 28, Leg., 81st Sess. (Tex. 2009).

[29] Section 17.042(2) allows jurisdiction when the tort is committed in whole or in part in Texas. For examples of the substantive limits of state power, particularly with respect to jurisdiction and the "dormant" Commerce Clause (because botnets often affect interstate commerce), TEX. CIV. PRAC. & REM. CODE § 17.042(2); *see* Gibbons v. Ogden, 9 Wheat. 1, 231-32 (1824) (recognizing that the Commerce Clause of the Constitution has a negative sweep as well as a positive one); American Library Assoc. v. Pataki, 969 F. Supp. 160 (S.D.N.Y. 1997) (striking down the Internet application of a New York Penal Code); *but see,* Jack L. Goldsmith & Alan O. Sykes, *The Internet and the Dormant Commerce Clause*, 110 Yale L.J. 785 (2001) (arguing that vigorous state regulation is permitted under the dormant Commerce Clause). Moreover, unlike "ALA v. Pataki", it can be argued that the type of interstate commerce conducted by botnets is not in the public interest, and that the burdens imposed on interstate commerce are exceeded by the local benefit of combating botnets. There is precedent for this view. Before the advent of the CAN-SPAM Act (15 U.S.C.A. § 7707 et seq.), most states have upheld their anti-spam statutes against Commerce Clause challenges. *See, e.g.,* State v. Heckel, 24 P.3d 404 (Wash. 2001). Unfortunately, the notoriously weak CAN-SPAM Act has preempted many state anti-spam statutes. *See, e.g.*, Gordon v. Virtumundo, Inc., No. 07-35487 (9th. Cir., August 6, 2009) (preempting Washington's anti-spam statute); Roger Allan Ford, *Preemption of State Spam Laws By The Federal CAN-SPAM Act*, 72 U. Chi. L. Rev. 355, 370-79 (2005). Fortunately, there is no federal equivalent of S.B. 28, so as of this writing, there is no preemption.

[30] At the time of this writing, there were approximately 3550 botnets that were composed of 429,000 bots being tracked by the online service ShadowServer.org. *See generally*, SHADOWSERVER, http://www.shadowserver.org/wiki/pmwiki.php/Stats/BotCounts. That is not the complete count of bots and botnets. Rather, it was an estimate simply of the ones known and tracked. Botnets vary markedly in size. Small botnets, however, can contain several thousand bots/zombies. On the other end of the spectrum, large botnets command in excess of one million bots.

VII. GATHERING THE EVIDENCE

The cause of action requires the gathering of evidence of one of the prohibited activities. While that may seem daunting, it is relatively easy if your client is the victim, or if one of the zombies resides on your client's network. Software is available for recording network traffic. Some of the software is released under an open source license, and is available for free download and use.[31] Commercial software suitable for finding bots is also available.[32] This software can be used to gather log information (records of network transactions) that can be authenticated and used as evidence in trial and other court proceedings.

VIII. FINDING THE PERPETRATOR(S)

An online organization like ShadowServer can help track botnets by providing a treasure trove of information, including the names and sizes of various botnets, and is a good place to start finding the command and control system used by the botnet's herder.[33] The most proven technique for uncovering botnet perpetrators is to "follow the money." If the bot sends spam, then finding the particular spam and then purchasing the product enables you to trace the payment to the originator of the spam. In some cases, the perpetrator is in Russia or Eastern Europe. However, many herders are in the U.S., and Texas is likely to have its share. Moreover, the U.S. still leads the world in spam production, with many spammers choosing to remain within its borders.[34]

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[31] There are several open source software applications suited to gathering evidence of botnets. The most popular is tcpdump. This program sniffs the network and presents the data in an understandable fashion. Using a power filter language, tcpdump can be used to show network traffic only for hosts and events of particular interest. *See generally,* TCPDUMP, http://www.tcpdump.org/, for downloadable versions (although OS X and Linux normally ship with the application pre-installed). The Windows version is called WinDump, *available at* http://www.winpcap.org/windump/. A second open source application is called Zenoss, which monitors the network and creates a database of discovered managed resources, such as servers, networks, and other devices. The resulting environment model provides a complete inventory of key systems, down to the level of resource components, including installed software such as bot/zombie software. Copies of the application for Linux, Windows and OS X are *available at* http://www.zenoss.com/download/links?creg=null. A similar application is called Nagios, which is used to monitor networks and key systems, such as servers, which can detect a distributed denial of service attack *available at* http://www.nagios.org/. There is a free (but not open source) software application that is designed specifically for finding bots called BotHunter *available at,* http://www.bothunter.net/. BotHunter is a passive network monitoring tool designed to recognize the communication patterns of malware-infected computers within a network. For those situations when the client has endured a distributed denial of service attack, an application called AWStats can be used to review the server log files and create reports needed for the litigation. AWStats is under the GNU General Public License *available at* http://awstats.sourceforge.net/.

[32] One commercial application is called "Silent Runner" and is available from AccessData Corporation. In the words of Steven Mical, Director of Network Forensics at AccessData, with Silent Runner, a bot will "stick out like a sore thumb." *Available at*, ACCESSDATA, http://accessdata.com/silentrunner.html.

[33] *See* SHADOW SERVER (Sep. 18, 2011), , http://www.shadowserver.org/wiki/.

[34] *See* MCAFEE AVERT LABS, *McAfee Threats Report: Second Quarter 2009*, http://www.mcafee.com/us/local_content/reports/6623rpt_avert_threat_0709.pdf.

IX. CONCLUSIONS

S.B. 28 is the first legislation directed specifically against botnets, herders, and those who rent botnets. Since the statute has been in effect for a short time, no litigation has been brought utilizing this statute as of this writing. However, botnets create a financial drain in Texas, the United States, and on international commerce, while contributing to the security threats often targeting major corporations. Fortunately, the statute is written such that gathering sufficient evidence for a lawsuit should be relatively easy. The substantial remedies afforded by S.B. 28 give businesses the incentives needed to challenge botnets, the greatest known Internet malady.

X. APPENDIX A

The following is the engrossed version of S.B. 28. The final version was not available at the time of this writing. Normally, the final version is available from the Texas Secretary of State's website.[35]

S.B. No. 28

AN ACT relating to the use of a computer for an unauthorized purpose; providing a civil penalty.

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF TEXAS:

SECTION 1. Section 324.002, Business & Commerce Code, as effective April 1, 2009, is amended by adding Subdivisions (1-a) and (9) to read as follows:

(1-a) "Botnet" means a collection of two or more zombies.

(9) "Zombie" means a computer that, without the knowledge and consent of the computer's owner or operator, has been compromised to give access or control to a program or person other than the computer's owner or operator.

SECTION 2. Subsection (a), Section 324.003, Business & Commerce Code, as effective April 1, 2009, is amended to read as follows:

(a) Section 324.052, other than Subdivision (1) of that section, and Sections 324.053(4), 324.054, and 324.055 do not apply to a telecommunications carrier, cable operator, computer hardware or software provider, or provider of information service or interactive computer service that monitors or has interaction with a subscriber's Internet or other network connection or service or a protected computer for:

(1) a network or computer security purpose;

(2) diagnostics, technical support, or a repair purpose;

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[35] *See* SECRETARY OF STATE, *Texas Secretary of State Hope Andrade*, http://www.sos.state.tx.us/.

(3) an authorized update of computer software or system firmware;

(4) authorized remote system management; or

(5) detection or prevention of unauthorized use of or fraudulent or other illegal activity in connection with a network, service, or computer software, including scanning for and removing software proscribed under this chapter.

SECTION 3. Section 324.005, Business & Commerce Code, as effective April 1, 2009, is amended to read as follows:

Sec. 324.005. KNOWING VIOLATION. A person knowingly violates Section 324.051, 324.052, 324.053, or 324.055 if the person:

(1) acts with actual knowledge of the facts that constitute the violation; or

(2) consciously avoids information that would establish actual knowledge of those facts.

SECTION 4. Subchapter B, Chapter 324, Business & Commerce Code, as effective April 1, 2009, is amended by adding Section 324.055 to read as follows:

Sec. 324.055. UNAUTHORIZED CREATION OF, ACCESS TO, OR USE OF ZOMBIES OR BOTNETS; PRIVATE ACTION. (a) In this section:

(1) ”Internet service provider” means a person providing connectivity to the Internet or another wide area network.

(2) ”Person” has the meaning assigned by Section 311.005, Government Code.

(b) A person who is not the owner or operator of the computer may not knowingly cause or offer to cause a computer to become a zombie or part of a botnet.

(c) A person may not knowingly create, have created, use, or offer to use a zombie or botnet to:

(1) send an unsolicited commercial electronic mail message, as defined by Section 321.001;

(2) send a signal to a computer system or network that causes a loss of service to users;

(3) send data from a computer without authorization by the owner or operator of the computer;

(4) forward computer software designed to damage or disrupt another computer or system;

(5) collect personally identifiable information; or

(6) perform an act for another purpose not authorized by the owner or operator of the computer.

(d) A person may not:

(1) purchase, rent, or otherwise gain control of a zombie or botnet created by another person; or

(2) sell, lease, offer for sale or lease, or otherwise provide to another person access to or use of a zombie or botnet.

(e) The following persons may bring a civil action against a person who violates this section:

(1) a person who is acting as an Internet service provider and whose network is used to commit a violation under this section; or

(2) a person who has incurred a loss or disruption of the conduct of the person's business, including for-profit or not-for-profit activities, as a result of the violation.

(f) A person bringing an action under this section may, for each violation:

(1) seek injunctive relief to restrain a violator from continuing the violation;

(2) subject to Subsection (g), recover damages in an amount equal to the greater of:

(A) actual damages arising from the violation; or

(B) $100,000 for each zombie used to commit the violation; or

(3) obtain both injunctive relief and damages.

(g) The court may increase an award of damages, statutory or otherwise, in an action brought under this section to an amount not to exceed three times the applicable damages if the court finds that the violations have occurred with such a frequency as to constitute a pattern or practice.

(h) A plaintiff who prevails in an action brought under this section is entitled to recover court costs and reasonable attorney's fees, reasonable fees of experts, and other reasonable costs of litigation.

(i) A remedy authorized by this section is not exclusive but is in addition to any other procedure or remedy provided for by other statutory or common law.

(j) Nothing in this section may be construed to impose liability on the following persons with respect to a violation of this section committed by another person:

(1) an Internet service provider;

(2) a provider of interactive computer service, as defined by Section 230, Communications Act of 1934 (47 U.S.C. Section 230);

(3) a telecommunications provider, as defined by Section 51.002, Utilities Code; or

(4) a video service provider or cable service provider, as defined by Section 66.002, Utilities Code.

SECTION 5. Subsection (a), Section 324.101, Business & Commerce Code, as effective April 1, 2009, is amended to read as follows:

(a) Any of the following persons, if adversely affected by the violation, may bring a civil action against a person who violates Section 324.051, 324.052, 324.053, or 324.054:

(1) a provider of computer software;

(2) an owner of a web page or trademark;

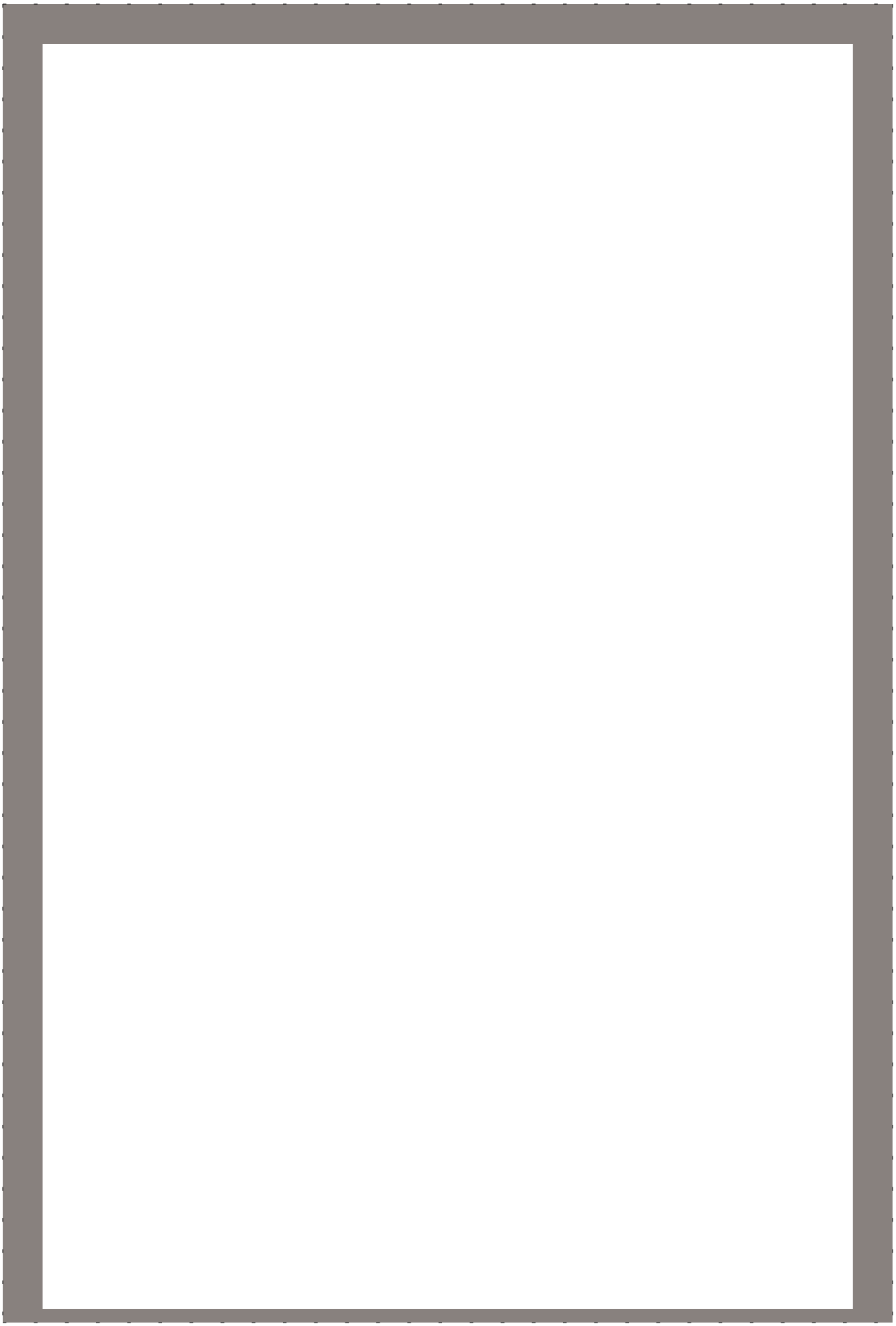
(3) a telecommunications carrier;

(4) a cable operator; or

(5) an Internet service provider.

SECTION 6. The changes in law made by this Act apply only to conduct that occurs on or after the effective date of this Act. Conduct that occurs before the effective date of this Act is governed by the law in effect at the time the conduct occurred, and that law is continued in effect for that purpose.

SECTION 7. This Act takes effect September 1, 2009.



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THE USE OF DIP FINANCING AS A MECHANISM TO CONTROL THE CORPORATE RESTRUCTURING PROCESS[1]

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[1] A prior version of this paper, entitled "DIP Financing: Too Much Lender Control?" was submitted to the American Bankruptcy Institute in connection with its Legislative Symposium, "Chapter 11 at the Crossroads: Does Reorganization Need Reform? A Symposium on the Past, Present and Future of U.S. Corporate Restructuring." The copyright was retained. The views set forth in this paper are the personal views of the authors and do not reflect the views of the law firm with which they are associated.

I. INTRODUCTION

Lenders routinely use debtor-in-possession ("DIP") financing agreements to gain substantial control over debtors in Chapter 11 and the bankruptcy reorganization process. However, the currently accepted degree of lender control over the Chapter 11 process has evolved into a major *de facto* change in the bankruptcy process that inhibits rehabilitation of distressed companies. This evolution has been accelerated by the overleveraging of debtors, the proliferation of secured financing, restrictions on the time for debtors to assume or reject leases, the exorbitant cost of DIP financing, and the availability of forms of DIP financing documents on the Internet. Whether this change is bad policy, or merely an economically efficient reallocation of capital, is an issue that courts, scholars, and practitioners are struggling to address.

A. The Trend Toward Increasing DIP Lender Control Over the Bankruptcy Process

Even scholars who praise the benefits associated with economically efficient liquidity events (*i.e.*, liquidations or going concern sales) acknowledge that Chapter 11 has changed dramatically, from a paradigm of court-supervised reorganization to a "secured-creditor driven system that results much more often in liquidation."[2] One manifestation of this sea change, in the world of bankruptcy reorganizations, is the reality that DIP financing does not work the way it used to. Today, DIP financing is frequently a mechanism by which lenders exert considerably more control over debtors and the bankruptcy reorganization process than ever before.

The widely discussed case of *Tenney Village*[3] illustrates this point. In *Tenney*, the court rejected a proposed DIP financing agreement that contained many of the DIP lender-control provisions that are customarily approved today. The *Tenney* debtor had financed condominiums and improvements at a ski area that it operated.[4] The proposed DIP financing agreement would have given the bank substantial control over the debtor as well as the Chapter

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[2] *Circuit City Unplugged: Why Did Chapter 11 Fail to Save 34,000 Jobs: Hearing Before the H. Subcommittee on Commercial and Administrative Law*, 111th Cong. 45-53 (2009) [hereinafter *Circuit City*] (Statement of Todd J. Zywicki, Prof., George Mason University School of Law).

[3] *In re* Tenney Vill. Co., Inc., 104 B.R. 562, 563 (Bankr. D.N.H. 1989).

[4] *Id.* at 563.

11 process, including: (1) bank approval of the specifications for the debtor's planned improvements; (2) direct supervision by the bank's consultant of the debtor's work on improvements; (3) the right to require the debtor to hire a new chief executive, subject to approval by the bank; (4) bank approval of the debtor's plan to market the condominiums; (5) bank approval of a new marketing firm hired to market the condominiums; (6) specific minimum unit values for sales of condominiums; (7) deposits of all proceeds from condominium sales into a collateral account at the bank, and the right to apply the balance in the collateral account to the outstanding obligation at any time; (8) granting of the highest administrative expense priority to the bank's claims; (9) vacating the automatic stay to permit foreclosure by the bank if any "termination event" occurred, such as (i) a plan of reorganization being confirmed over the bank's objection, (ii) a third party obtaining relief from the automatic stay without the bank's consent, and (iii) any creditor or other party in interest taking any action against the bank; and (10) waiver of the debtor's potential claims and defenses against the bank, including the right to assert preference, fraudulent transfer and other avoiding powers.[5] Moreover, the DIP financing agreement in *Tenney* was troubling[6] because it was a roll-up that granted the bank a mortgage securing the outstanding prepetition debt (roughly $16,600,000) *and* the post-petition debt ($1,000,000 in new money).[7] Further, the term of the loan was short. The entire debt was due roughly five months after the date of the DIP financing agreement.[8]

The bankruptcy court found the lender's degree of control "shocking."[9] In rejecting the DIP financing agreement, the court concluded:

> "The Financing Agreement would pervert the reorganizational process from one designed to accommodate all classes of creditors and equity interests to one specially crafted for the benefit of the Bank and the Debtor's principals who guaranteed its debt. It runs roughshod over numerous sections of the Bankruptcy Code. Under its rights of approval and supervision, the Bank would in effect operate the Debtor's business. The Code permits this to be done only by a debtor or trustee."[10]

The court went on to enumerate the ways in which the contemplated lender control violated numerous Bankruptcy Code provisions.

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[5] *Id.* at 567.

[6] *In re* Dynaco Corp., 162 B.R. 389, 397 (Bankr. D.N.H. 1993), acknowledging "the egregious overreaching by the proposed new financing party [in *Tenney*], including the proposed inappropriate granting of new security for that party's own prepetition unsecured claims."

[7] *See* Tenney, 104 B.R. at 563.

[8] *Id.* at 567.

[9] *Id.* at 568.

[10] *Id.*

Tenney was decided in 1989; yet, today, *Tenney*-style DIP financing agreements are commonplace. For example, in *Yellowstone*,[11] the debtor operated an exclusive, membership-based ski resort. The court approved a DIP loan (at 15% interest) that gave the DIP lender significant control over the bankruptcy process via "restructuring benchmarks," which specified the dates by which the debtor was required to collect membership dues, file a Chapter 11 plan, and have the plan confirmed.[12] If the benchmarks were not met, the debtor agreed to immediately commence a Section 363 sale of substantially all its assets.[13] Likewise, in *Lyondell*,[14] the DIP lenders extended a roll-up loan for $8 billion. The DIP financing agreement gave DIP lenders substantial control over the Chapter 11 process, including drop-dead dates for delivering a draft plan of reorganization within seven months, filing the plan within eight months, and confirming the plan within eleven months. The cost of interest plus fees was 20%. Similarly, in *Reader's Digest*,[15] the DIP lenders were among the senior prepetition lenders who were owed $1.6 billion. The DIP lenders provided $150 million in new money at an aggregate rate of at least 14.5% interest (based on a LIBOR floor). The DIP lenders obtained significant control of the reorganization process, to the extent that they required the debtor to file a Chapter 11 plan of reorganization within 75 days and have it approved within 195 days (with the possibility of a three-month extension if conditions in the loan agreement were met).[16] Further, in *Propex*,[17] the initial DIP loan expired and the initial DIP lenders refused to extend the maturity date and provide exit financing.[18] The subsequent DIP lender (a prepetition secured lender) used the DIP financing agreement to become the stalking horse bidder. Moreover, the agreement included a provision granting the DIP lender the right to approve bid procedures.[19] Consequently, the DIP lender was able to purchase the company, while earning $3 million in fees, for a $65 million DIP and exit facility with an interest rate of LIBOR plus 10%.[20] Finally, in the *Square Mile Energy* case, out of Houston, Texas, the effective rate of the DIP loan was 8% *per month* (*i.e.*, 96% annual interest).

Thus, there is a marked trend toward lenders seeking to dominate the Chapter 11

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[11] *In re* Yellowstone Mt. Club, LLC, No. 08-61570-11, 2008 WL 5875547 (Bankr. D. Mont. Dec. 17, 2008).

[12] *Id.* at *6.

[13] *Id.* at *6-7.

[14] *In re* Lyondell Chem. Co., 402 B.R. 571, 576 (Bankr. S.D.N.Y. 2009); Hesse, Kent, *DIP Financing: Where is the Liquidity to Reorganize and What Will it Cost You*, 27th Annual Advanced Business Bankruptcy Course, Oct. 1-2, 2009, p. 18-21.

[15] *In re* Reader's Digest Assoc., Inc., (Case No. 09-23529 (RDD) (Bankr. S.D.N.Y. 2009).

[16] "The DIP Financing Motion," *In re* Reader's Digest Assoc.,, p. 5-11 (Bankr. S.D.N.Y. August 24, 2009); *see also* Hesse, *supra* note 14, at 17.

[17] *In re* Propex Inc., 415 B.R. 321, 323 (Bankr. E.D. Tenn. 2009)*; See also* Hesse, *supra* note 14, at 21.

[18] Hesse, *supra* note 14, at 21.

[19] *Id.* at 21.

[20] *Id.*

process and environment at the onset of cases by way of the DIP order.[21] Further examples of this trend include *In re Gemini Cargo Logistics, Inc.,* where: the debtor filed on June 18, 2008; the court was required to approve auction procedures by June 27, 2008; the debtor was required to enter into a sale of substantially all its assets by August 8, 2008; and the court was required to approve the sale by August 13, 2008.[22] These requirements were enumerated as conditions that, if not met, would terminate the DIP facility. The DIP lender's credit bid was the only qualified, and thus winning, bid.[23] Therefore, the result was equivalent to a foreclosure sale or retention of collateral in satisfaction of the obligation. Similarly, in *In re Whitehall Jewelers Holdings, Inc.*, the debtor filed on June 23, 2008, and the court was required, by the terms of the DIP facility, to approve bidding procedures by July 10, 2008 and to approve a sale by August 4, 2008.[24] Upon notice of an event of default all proceeds of the collateral would go to the DIP lender and the debtor would not have the right to use such proceeds or any other cash collateral. Likewise, in *In re Tronox Inc.*, the DIP credit agreement required sale of the debtor within six months of closing.[25] The equity committee in the case alleged that the decision to sell was a result of DIP lender demands, rather than independent judgment of the debtor, and the equity committee and the unsecured creditors alleged that the DIP lender was requiring a "fire sale."[26] Finally, in *In re Foamex International, Inc.*, the DIP lender not only provided for sale milestones that established a timeline for sale of the debtor, but the DIP facility also contained a provision requiring a $1.8 million fee if the facility was prepaid.[27] The DIP lender proceeded to acquire the debtor via a credit bid.[28]

While each of the foregoing cases is merely illustrative, the ever-increasing use of DIP financing as a lever to gain control of the bankruptcy process explains how DIP lenders have taken control of many aspects of operating the debtor that used to be within the province of the debtor-in-possession. These operational functions include: supervising the implementation of capital improvements; setting prices for the sale of debtor assets; requiring the debtor to hire a new CEO or CRO, subject to the DIP lender's approval; and requiring the debtor to replace existing service providers, such as marketing companies, with lender-approved service providers.

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[21] Melanie L. Cyganowski, John C. Wright, & Pauline Yedreyeski, "Chapter 11: Liquidating Cases & Asset Disposition – the Bankruptcy Sale Process," Materials prepared for the 14th Annual Bankruptcy Conference of The Capital Region Bankruptcy Bar Association & The Central New York Bar Association, Saratoga Springs, NY, November 7, 2009, at 2.

[22] *In re* Gemini Cargo Logistics, Inc., 08-18173 (AJC) (Bankr. S.D.Fla. June 20, 2008).

[23] *See supra,* note 22.

[24] Cyganowski, *supra* note 21, at 4; *In re* Whitehall Jewelers Holdings, Inc., No. 08-11261 (KG), 2008 WL 2951974 (Bankr. D. Del. July 28, 2008).

[25] Cyganowski, *supra* note 21, at 4-5; *In re* Tronox Inc*.,* 429 B.R. 73, 81 (Bankr. S.D.N.Y. 2010).

[26] *Tronox*, 429 B.R. at 81.

[27] Cyganowski, *supra* note 21, at 11-12; *In re* Foamex Int'l Inc., 382 B.R. 867, 870 (D. Del. 2008).

[28] *Foamex,* 382 B.R. at 870.

Likewise, DIP lenders have taken on many of the functions that used to be the sole bailiwick of the bankruptcy court including: setting the timeline for filing a plan and requiring a plan to be confirmed; setting timetables for the disposition of specific assets; requiring DIP lender approval of auction procedures in connection with a liquidation or going concern sale; and requiring the debtor to waive the estate's preference claims, fraudulent transfer claims, and avoidance powers.

II. THE ARGUMENT THAT CURRENT LEVELS OF DIP LENDER CONTROL ARE EXCESSIVE

There is concern among bankruptcy practitioners and scholars that Chapter 11 no longer serves the objective of reorganizing businesses to preserve jobs, benefit the communities in which they are located, and thereby serve the national interest in having a vibrant economy.[29] Chapter 11 was designed to be a tool to reorganize the capital structures of distressed businesses that are the natural result of excess credit in this credit-intensive world.[30] The purpose of Chapter 11 is to rehabilitate such businesses by balancing the needs of debtors, the rights of creditors, and the interests of business owners.[31] The degree of control currently wielded by DIP lenders arguably upsets this balance.

From a policy perspective, businesses may be regarded as more than the sum of their financial, human, and physical capital. It takes years for a successful business to build and sustain relationships, as it takes a great amount of time and effort to develop integrity. Businesses are integral to the vibrancy of communities that rely on the lifeblood of employment to foster civic engagement and political participation. Hence, successful businesses are one of the fundamental building blocks of our democracy. It follows that we should be concerned with legal roadblocks and market practices that hinder the rehabilitation of distressed companies, particularly those companies whose capital structures require reorganization when the excess credit in the capital markets dries up. When a company fails, the relationships on which it was built are destroyed, the communities in which it is located suffer, and civic life is diminished. An awareness that the values that society holds dear are not fully recognized on a balance sheet, coupled with the knowledge that it is always easier to destroy than it is to create, counsels against the cavalier destruction of distressed businesses.

From this perspective, the concern that secured lenders should get what they bargained for, even in bankruptcy, may be overblown. After all, lenders take risks, one of which is the risk of reduced payment or nonpayment. When such risks manifest themselves, and thereby increase the costs of credit to more accurately account for such risks, the result is

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[29] *Circuit City, supra* note 2, at 10-25 (Statement of Harvey R. Miller, Weil, Gotshal & Manges, LLP).

[30] *Id.* at 12-13.

[31] *Id.* at 13.

to reduce the excess credit in the market that otherwise leads to unsustainable bubbles. Thus, the risk of delayed or reduced payment in bankruptcy can operate as a damper that moderates the otherwise devastating effects of the boom and bust cycle. Moreover, accepting the reality of such risks should lead to a more sensible, long-term view based on financial institutions holding performing loans rather than initiating and selling loans. Likewise, the resulting increase in cost of capital should lead to more prudent, long-term financial planning by borrowers. Both lenders and borrowers would ultimately benefit from focusing less on short-term profits and avoiding unsustainable levels of leverage. For these reasons, it may be wise policy to maintain bankruptcy laws and foster restructuring practices that force lenders to accept a sizeable portion of the responsibility when the risk of insolvency manifests.

III. LEGISLATIVE SOLUTIONS

Courts are often presented with a Hobson's choice: approve the DIP loan on the terms dictated by the lenders, or call the lender's bluff and risk imminent liquidation of the debtor. In addition, even though a given court may decline to approve DIP financing arrangements containing objectionable terms, other courts may be more sympathetic to the demands of the lenders. The result is forum shopping and non-uniform application of Chapter 11 law. Accordingly, it is likely that only legislative changes will effectively change the DIP lending landscape.

One legislative policy prescription would be to disallow treatment of rolled-up debt as an administrative claim. Under this rule, lenders would only be allowed to treat "new money" as an administrative claim, not prepetition obligations. This solution is analogous to the treatment of cash collateral under cases such as *In re 360 Inns*, where the court found that "continuing use of [debtor] revenues should not be construed as post-petition advances of credit in the same context as if new monies were being poured into the debtor by [the prepetition lender]."[32] For example, if a prepetition lender were owed $10 million in prepetition debt, and rolled that debt into an $11 million "defensive DIP" financing agreement while providing only $1 million of new money, then the DIP lender would only be allowed an administrative claim for the new money contributed to the estate. Hence, the prepetition lender would be left with a $1 million administrative claim and a $10 million prepetition claim. Further, if the prepetition loan is either unsecured or under-collateralized, then interest would only accrue on the new money and the lender would not be entitled to reimbursement for attorney's fees and other costs attributable to the prepetition loan.[33] An amendment to the Bankruptcy Code that embodies this concept could be applied straightforwardly without unduly disrupting commercial lending practices.

Other policy changes that would reduce lender control of the restructuring process,

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[32] *In re* 360 Inns, Ltd., 76 B.R. 573, 578 (Bankr. N.D.Tex. 1987).

[33] *See* 11 U.S.C.A. § 506 (West 2011).

while restoring control and discretion to the bankruptcy courts, would be to prohibit a DIP lender from dictating auction procedures, the form of a plan of reorganization, the timing of asset sales, and the timing of the plan of reorganization. The concept that creditors should not be allowed to derail the confirmation of a plan and gain control of the debtor under all circumstances is already enshrined in the "good faith" requirement of Section 1126(e) and the *Alleghany* doctrine.[34] A similar version of this concept could be applied to prevent DIP lenders from requiring the timing and form of a Chapter 11 plan to be subject to their approval. Likewise, the Bankruptcy Code could be amended to prohibit waiver of the estate's preference claims, fraudulent transfer claims, and avoidance powers against DIP lenders.

Lenders assert that such provisions will restrict the availability of DIP financing and result in more liquidations, fewer reorganizations, and lower returns to creditors. The counterargument to that is that there is no demonstrable connection between restrictions on DIP financing and the availability or cost of DIP financing. Further, the enormous charges recently extracted by DIP lenders is indicative of a contract of adhesion encouraged by the perceived unwillingness of courts to decline to approve oppressive DIP facilities when it is clear that for the lenders to maximize their recovery, the enterprise value of the debtor must be preserved. While a theoretical economic perspective assumes that the provision of DIP credit follows classic rational economic principles, in reality, the actions of "defensive DIP" lenders are often predicated on the parochial interests of the diverse members of the lending syndicate.

The Bankruptcy Code was predicated on the "George Bailey"[35] model of a lender who makes a loan with the intent of some day collecting on that loan. This model no longer accurately describes market practices. Instead, in today's lending market the agent for a syndicate of lenders arranges a loan for a significant fee, often millions of dollars. The agent may keep a small portion of the credit but will "syndicate" the loan to several, or as many as hundreds, of members of the syndicate, each of whom purchases small slices of the loan. These slices are then traded back and forth in the market. The syndicate members are often funds who never intend to collect on the loans. These funds often enter into derivative contracts, such as credit default swaps to hedge their positions. They also frequently purchase debt or equity at different levels of the capital structure of the debtor. Consequently, the motives of syndicate members range from the classic model of the lender who wants to maximize the collection possibilities of the loan by the successful reorganization of the debtor to the syndicate member who has purchased a slice of the credit at a deep discount and wants to liquidate the collateral as quickly as possible, to the institutional lender who simply wants to avoid a write off of its slice of the loan this quarter, to the hedge fund owner of a slice who has shorted other securities of the debtor or who holds credit default swaps and would therefore profit from the debtors' demise. The DIP loan may be utilized for any of these purposes, or as

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[34] *See In re* DBSD N. Am, Inc., 421 B.R. 133, 138-140 (Bankr. S.D.N.Y. 2009) (citing *In re* Allegheny Int'l, Inc., 118 B.R. 282 (Bankr. W.D.Pa 1990)).

[35] *See* IT'S A WONDERFUL LIFE. (RKO-Pathé Studios 1946). (Shown many times every Christmas season).

the first step in a "loan to own" strategy.

Congress must recognize the marketplace reality of these competing interests, balancing the positive aspects of debtor reorganization against the legitimate needs and rights of lenders. Furthermore, Congress must also discard the rhetoric of those who have a vested interest in perpetuating the myth that the availability of DIP financing and its pricing are functions of rational measures of risk.

Some lenders also suggest that instead of implementing legislative changes that would decrease DIP lender control, the solution is to focus on pre-bankruptcy planning so that distressed companies will file Chapter 11 petitions earlier. The problem with this proposal is that the decision-makers who decide whether to file a Chapter 11 do not have an incentive to file early. In fact, they have every incentive not to file.[36] For closely held corporations, the negative incentives are particularly acute because the managers are typically also the shareholders and the guarantors of the company's debt.[37] If the company files for Chapter 11 protection, these owner-managers will likely see their equity wiped out under the absolute priority rule,[38] and they will ultimately be personally liable for payment of their guaranties. Even in large public corporations, the incentives are askew because executives will likely lose their jobs[39] as well as the value of their stock and stock options if they decide to file a Chapter 11 petition. The net result of such incentives is that the opportunity for creditors and equity holders to realize the going concern value from a carefully planned successful reorganization is often lost.[40] Because the incentives of decision-makers are misaligned, rational decision-makers operating in their individual best interests at each step of the process contribute to a sub-optimal aggregate systemic result.

It has also been suggested that the 120-day limit on exclusivity, which may be extended to a maximum of 18 months, upon approval of the court,[41] and the application of the absolute priority rule[42], which often eliminates the equity interests in a Chapter 11 case, act as

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[36] Richard E. Mikels & Peter S. Kaufman, *Balancing Creditor and Equity Interests Provides Incentive to Utilize Chapter 11 For Mutual Benefit*, 22-10 ABI Journal 26 (December 2003/January 2004), accessed on November 3, 2009 at http://www.abiworld.org/AM/Template.cfm?Section=Home&Template=/MembersOnly.cfm&ContentID=35077&FusePreview=False.

[37] *Id*. at 5.

[38] *See* 11 U.S.C.A. § 1129(b)(2)(B)(i-ii) (West 2011).

[39] *Lehman Brothers, Sharper Image, Bennigan's and Beyond: Is Chapter 11 Bankruptcy Working*: *Hearing Before the H. Subcommittee on Commercial and Administrative Law*, 110th Cong. 18-24 (2008) [hereinafter *Lehman Brothers*] (Barry E. Adler, Esq., Professor, New York University School of Law) (*citing* Ayotte, K.M. & Morrison, E.R., "*Creditor Control and Conflict in Chapter 11*," 2nd Annual Conference on Empirical Legal Studies).

[40] *See supra* note 37 at 5.

[41] 11 U.S.C.A. § 1121(b-c) (West 2011).

[42] *See supra* note 39.

a disincentive to earlier filing by debtors.[43] However, the restrictions on exclusivity may not significantly alter the timing of Chapter 11 filings or the contents of DIP financing agreements because DIP financing agreements would likely continue to include provisions that set dates by which reorganization plans must be submitted and confirmed. These provisions may require the sale of assets of the debtor by dates certain long before the expiration of the exclusivity period. Elimination of the absolute priority rule is problematic because creditors will contend, with some justification, that such a change would inequitably alter the negotiating balance away from creditors, and counterproductively result in tighter DIP restrictions by lenders to protect their interests.

IV. THE ARGUMENT AGAINST REDUCING DIP LENDER CONTROL

On one hand, many scholars and practitioners have expressed concern that DIP financing is not working effectively, thereby contributing to the difficulty of successfully reorganizing debtors in Chapter 11. On the other hand, some argue that nothing should be done to change the Bankruptcy Code provisions relating to DIP financing. The argument is that existing levels of DIP lender control over the bankruptcy process do not amount to bad policy, but instead function as part of a relatively efficient (though admittedly imperfect) market that channels human, physical, and financial capital towards its most productive uses. From this perspective, the system is working as well as can be expected, given the sudden collapse of the credit markets and the financial sector, as well as the ongoing recession. After all, "[b]ankruptcy is uniquely Darwinian"[44] in that it adapts to current economic conditions. It may be more accurate to attribute unprecedented high levels of Chapter 11 liquidations to market-driven phenomena and unexpected financial disruptions, rather than *de facto* legal changes such as DIP lender dominance of the bankruptcy process.

In the past, when the bankruptcy process more aggressively allowed debtors to confirm reorganization plans, distressed companies routinely emerged from bankruptcy, regardless of whether they had cured the operating problems that brought the firm into bankruptcy in the first place.[45] Thus, it should not be surprising that nearly a third of the large, publicly traded firms that reorganized in the United States from 1991 to 1996 went out of business within five years.[46] Likewise, more than 40% of firms that reorganized in Delaware and 20% of firms that reorganized in the Southern District of New York filed for bankruptcy protection a second time within five years.[47] In addition, the managers who oversaw the

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[43] *See supra* note 37 at 5.

[44] Matt Miller, *From Liquidity to Liquidation*, THEDEAL MAGAZINE (September 11, 2009, 1:52 PM), http://www.thedeal.com/newsweekly/features/from-liquidity-to-liquidation.php.

[45] *Lehamn Brothers, supra* note 40, at 20-21 (Congressional Testimony of Barry E. Adler).

[46] LoPucki, L. Doherty, Joseph W., *Why Are Delaware and New York Bankruptcy Reorganizations Failing*, 55 Vanderbilt L. Rev. 1933 (2002).

[47] *Id.*

descent of a company into bankruptcy frequently remained in control of the debtor during bankruptcy, and sometimes after.[48]

In contrast, in the new era of creditor dominance in Chapter 11, when a company files for bankruptcy the primary secured creditor characteristically wrests control of the case immediately from the debtor's managers.[49] The DIP loan is often the vehicle for such control, because the DIP lender provides crucial financing with strings attached, such as vesting the lender with management prerogatives.[50] Consequently, top managers now lose their jobs almost three-quarters of the time, and the bankruptcy process is commonly converted from a protracted negotiation to an efficient liquidation.[51]

Without denying the costs that liquidation imposes on suppliers, employees, and local communities, advocates of the status quo point out that a new financial structure will not rehabilitate a business that is not economically viable.[52] Firms do not enter bankruptcy randomly.[53] Many, perhaps most, fail for the old-fashioned reason: a poor business plan poorly executed. Filing for Chapter 11 cannot help a company that offers an expensive product that customers do not want.[54] Society is not well served if a futile reorganization attempt consumes resources the creditors could otherwise reinvest, while merely delaying the inevitable demise of the business.[55]

Moreover, cases like *First Magnus*[56] show that bankruptcy courts continue to scrutinize DIP financing agreements in light of the facts, circumstances, and economic context and retain the power to reject lender overreach, as they deem appropriate. In *First Magnus*, a case filed before the collapse of Lehman Brothers and the onset of the recent economic downturn, the DIP lender agreed to provide a $15 million credit facility in exchange for 18.25% interest (prime rate plus 10%), a closing fee of 7% ($1,050,000), a $75,000 due diligence fee, and a $5,000 monthly audit fee. The exchange was also for a super priority lien over all administrative expense claims and unsecured claims, a first priority security interest in all debtor's assets and proceeds,[57] and a provision stating that interested parties could not

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[48] *Id*. at 20.

[49] *Testimony of Barry E. Adler* (citing D. G. Baird and R. K. Rasmussen, *Chapter 11 at Twilight*, 56 Stanford L. Rev 673-699 (2003) and D.A. Skeel, *Creditors' Ball: The 'New' New Corporate Governance in Chapter 11*, 152 Penn. L. Rev. 917-951 (2003)).

[50] *Id*.

[51] *Id*. at 21.

[52] *Id*. at 22.

[53] *Id*.

[54] *Supra* note 50, at 22.

[55] *Id*.

[56] *In re* First Magnus Fin. Corp., 390 B.R. 667 (Bankr. D. Ariz. 2008).

[57] "The DIP Financing Motion." *In re* First Magnus Fin. Corp., p.16-17 (Bankr. D. Ariz. August 21, 2007); S*ee*

object to approval of the DIP financing facility based on the adequate protection provided for in the agreement.[58]

The court denied the DIP financing facility on several grounds including the overreaching by the DIP lender, the potentially adverse impact on prepetition secured creditors, and the "overly expensive credit."[59] The court calculated the effective cost of the loan, after fees and interest, as $3,922,500, or 26.15% of the loan.[60] Thus, some courts are still willing to reject proposed DIP financing where DIP lenders seek levels of control and financial terms that appear unreasonable under the facts and circumstances of the case. However, as discussed above, while a bankruptcy court may reject a particular DIP financing proposal in a given case, the result will likely be forum shopping rather than systemic changes that reduce lender control.

Conversely, cases such as *General Growth Properties*[61] show that when a group of debtors has significant cash flow and valuable assets, it can obtain a workable DIP loan, even in these times of tight credit. In *General Growth Properties*, a syndicate of DIP lenders extended a $400 million, twenty-four month loan, which included a provision giving the debtor 210 days to bring avoidance actions.[62] Roughly $215 million of this loan was designated to pay a different prepetition lender, and the estate received approximately $185 million in new money.[63] Although the DIP lender exercised some control in *General Growth Properties*, this control is less invasive than in other cases discussed above, and the debtor's prospects for reorganization have not been impeded.[64] More reasonable DIP financing is available when a debtor seeks bankruptcy protection in a timely fashion, rather than waiting until it has no other source of operating funds.

Lenders legitimately contend that if the lender is under-collateralized, then the lender experiences all of the downside of the reorganization process and should be able to maintain a high degree of control over the operations of the debtor during the Chapter 11 reorganization. Lenders also contend that increased risk will result in higher credit cost and limited availability of DIP credit to debtors. These considerations must be balanced with the overall objective of

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also O'Neil, Patterson, & Warner, *Current Developments in DIP Financing, Absolute Priority, and Pre-Confirmation 363 Sales*, 2009 Southwest Bankruptcy Conference, American Bankruptcy Institute, Sept. 10-12, 2009, p. 513-515.

58 "The DIP Financing Motion," at 20.

59 "The DIP Financing Order." *In re* First Magnus Financial Corp., p.1 (Bankr. D. Ariz. August 21, 2007).

60 *Id.*

61 *In re* Gen. Growth Props., Inc.,., 409 B.R. 43, 46 (Bankr. S.D.N.Y. 2009).

62 "The DIP Order." *In re* Gen. Growth Props., p.11-12 (Bankr. S.D.N.Y. April 16, 2009); *See also* O'Neil, *supra* ,note 60, at 523.

63 "The DIP Order," at 7.

64 *See* Daniel J. Sernovitz, *General Growth File Reorganization Plan*, BIRMINGHAM BUSINESS JOURNAL (July 13, 2010, 2:44 PM), http://www.bizjournals.com/birmingham/stories/2010/07/12/daily16.html.

reorganization.

A key function of Chapter 11 is to distinguish between firms that have failed and those that are merely in financial distress.[65] Indeed, when an economically failed company liquidates shortly after entering Chapter 11, the decisive resolution of the company's prospects clears the way for more vibrant competitors to grow, and reallocates the financial, human, and physical capital of the enterprise.[66] On the other hand, the premature liquidation of a viable business without providing the opportunities that Chapter 11 was designed to afford, has serious negative consequences. Therefore, appropriate legislative changes should be explored to meet the legitimate requirements of lenders, suppliers, landlords, the credit markets, employees, other creditors, communities, and the broader economy.

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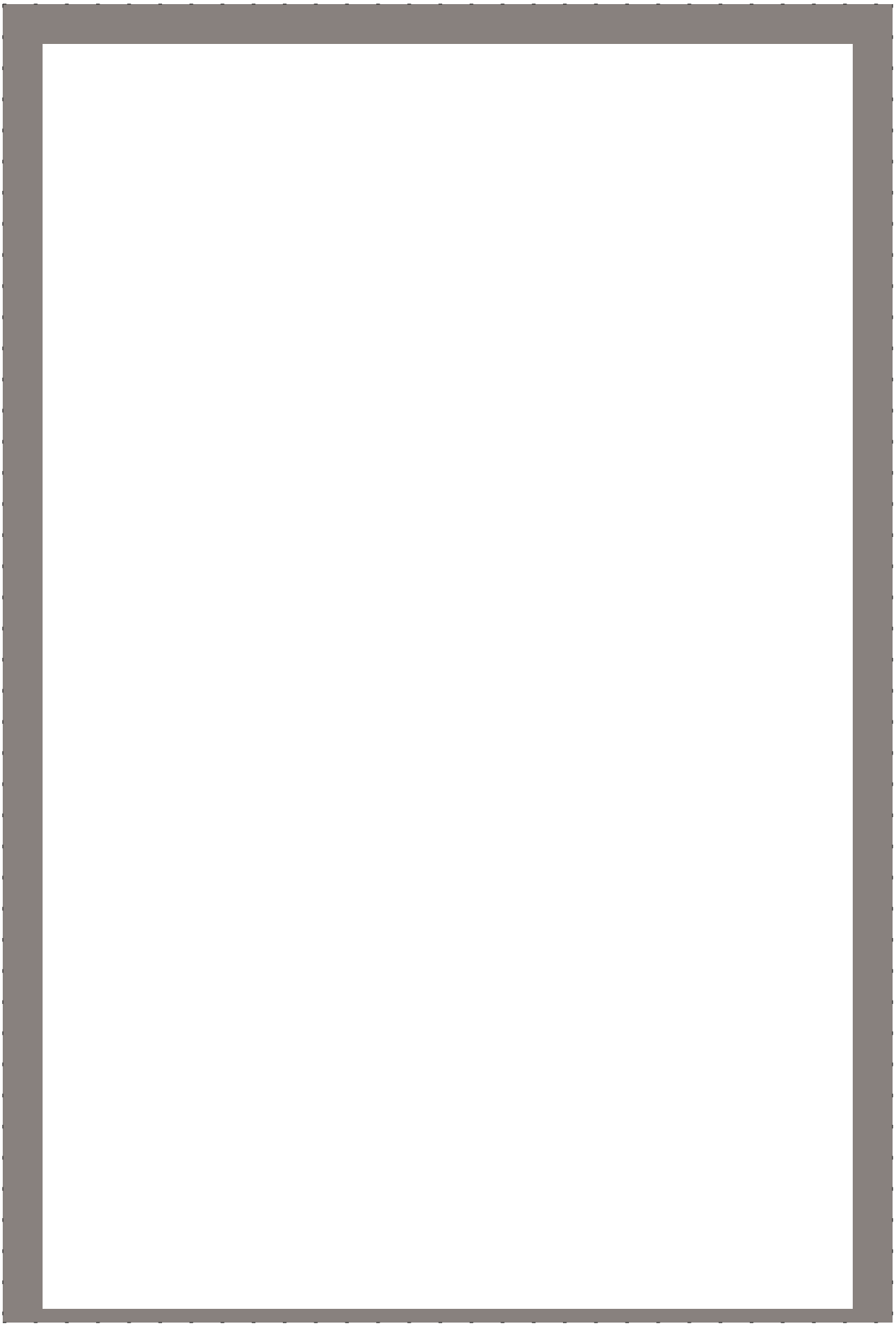
[65] *Circuit City, supra* note 2, at 47 (Congressional Testimony of Todd J. Zywicki).

[66] *Id.*



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THREE SUGGESTIONS FOR THE TEXAS LIMITED LIABILITY COMPANY LAW

Val Ricks*

The following article was drafted and circulated informally before the 2011 Texas Legislative Session. Though the Legislature follows its own agenda, the author was pleased to see that changes made to the Texas Business Organizations Code in SB 748, signed by the Governor on May 27, 2011, correct the problems addressed in Parts I and II of this paper. Thus, though the statutes discussed in Parts I and II of the paper still apply to cases arising prior to the effective date of these new amendments, Parts I and II are now valuable primarily for their justifications of the amendments and the history of the prior provisions.

The Legislature also passed a bill purporting to address the third suggestion, described in Part III. SB 323, signed by the Governor on May 9, 2011, purports to impose on limited liability companies the restrictions on entity veil-piercing imposed on Texas corporations under Texas Business Organizations Code section 21.223. The passage of this bill moots this article's first two objections to importing section 21.223's rules against limited liability company members, though Parts III.A and III.B remain valuable generally as a warning against importing Business Organizations Code provisions from one Title to another. Part III.B also includes a helpful critique of section 21.223.

SB 323 fails, however, to address the third objection to application of section 21.223 to limited liability companies, namely, that section 101.113 of the Texas Limited Liability Companies Law forbids suing both the limited liability company and its members in a single suit. Because, as Part III.C explains, veil-piercing in Texas is merely a remedy and not a cause of action, section 101.113 presents a formidable obstacle to any limited liability company veil-piercing (an obstacle that courts to date seem entirely to have overlooked, though no one seems to have argued the section to them). Members cannot be joined to the suit against the limited liability company, and a second suit against the members lacks a cause of action.

SB 323, therefore, places Texas veil-piercing law for limited liability companies in a conundrum. Sections 101.113 and 101.114 (which states generally that members are not liable for the limited liability company's obligations) strongly suggest that no veil-piercing of limited liability companies is possible under Texas law. Cases holding otherwise thus far have clearly violated section 101.113. But SB 323 places in the Texas Limited Liability Company Law the limitations on veil-piercing that apply in the Texas Corporation Law. How can limitations on veil-piercing apply if veil-piercing is impossible? SB 323 is superfluous unless veil-

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piercing against a limited liability company member is possible, but section 101.113 makes veil-piercing against a limited liability company member impossible. How to resolve this contradiction is a topic of another paper. In the meantime, if the issue comes up in litigation, one hopes the courts have a sense of humor. Because SB 323 does not address the topic of section 101.113, I believe that section 101.113 should continue to control, even if its application renders SB 323 superfluous.

A few years ago, I decided to teach business entity law primarily from the Texas Business Organizations Code (the "TBOC"). The Code draws heavily from the uniform acts with respect to corporations and partnerships,[1] especially for its operative language, so students would in substance be learning law applicable in most states.[2] But I wanted students to realize that no uniform act is ever passed as drafted. Local color enlivens local law, and all law is in a sense local.[3]

The TBOC provisions applicable to limited liability companies (LLC), however, were drafted without the benefit of a uniform act. The Texas LLC Act was passed before the Uniform Limited Liability Company Act existed. But the LLC code was not drafted "freehand."[4] Many of the Texas provisions resemble code applicable to corporations or limited partnerships. Others have less precedent. What I discovered, however, is that the LLC code contains some provisions that are very difficult to explain to students (well, and also to myself). In some cases the borrowed corporate or partnership provision comes with defects that are replicated in the limited liability code, and in some cases the corporate or partnership provisions are applied without considering the LLC's different nature. Some provisions I am just at a loss to explain.

In this paper, I describe what I believe are the three most inexplicable Texas LLC laws. The first (described in Part I) is the provision purporting to address resolution of managers', managing members', and officers' conflicts of interest. This statute is drawn to mimic exactly a provision applicable to corporations. But the statute actually contains no language addressing conflicts of interest! The second statute (in Part II) addresses agency and the LLC. This provision was taken from the partnership code but adapted to the LLC in a manner I find befuddling. Read literally, it abolishes the common law of agency as applied to agents of LLCs. The third provision (Part III) is a bit of corporate code addressing veil-piercing that does not exist in the LLC code but is being applied to LLCs by the courts as if it did. It is difficult to explain why this provision should be imported, and the code forbids it.

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[1] The corporate provisions obviously reflect the influence of the Revised Model Business Corporations Act (1984) and some amendments made since 1984. The general partnership and limited partnership provisions obviously reflect those of the Revised Uniform Partnership Act (1997) and Revised Uniform Limited Partnership Act (1976 & 1985), respectively, and some subsequent amendments to those acts.

[2] The Revised Model Business Corporations Act has been adopted in thirty or more states. 1 Model Bus. Corp. Act Ann. ix & nn.1-2 (2009); William B. Chandler III & Anthony A. Rickey, *Manufacturing Mystery: A Response to Professors Carney and Shepherd's "The Mystery of Delaware Law's Continuing Success*," 2009 U. Ill. L. Rev. 95, 97 N.11. The Uniform Partnership Act (1997) has been adopted in 37 states and the Virgin Islands. Uniform Laws Annotated, Unif. Partnership Act 1997 Refs & Annos (2010). The Uniform Limited Partnership Act (1976 and 1985 amendments) was adopted in at least 37 states and the Virgin Islands. Uniform Laws Annotated, Unif. Ltd. Part. Act 1976 Refs & Annos (2010). The 2001 Revised Uniform Partnership Act has been adopted in 15 states. *See* Uniform Laws Annotated, Unif. Ltd. Part. Act 2001 Refs & Annos (2010).

[3] I bring Delaware and other law into the class as needed for a complete understanding.

[4] The Texas Limited Liability Company Act was passed in 1991. Acts 1991, 72nd Leg., ch. 901, § 46, eff. August 26, 1991. The Uniform Limited Liability Company Act was passed in 1994. Uniform Laws Annotated, Unif. Ltd. Liability Co. Act 2006 Refs & Annos (2010). "By that time nearly every state had adopted an LLC statute." *Id.* at Prefatory Note.

Each section of this paper ends with a plea to the legislature to change the provisions discussed here. I suggest ways the legislature might fix the first two; the last I leave to our representatives. If the legislature will take me up on these suggestions, I will be able to spend more class time on other equally pressing legal issues and will spend less time trying to compensate with long explanations for what are probably primarily drafting failures.

I. CONFLICTING TRANSACTIONS INVOLVING GOVERNING PERSONS OR OFFICERS: A DRAFTING ERROR THAT GUTS THE STATUTE

A statute titled "Contracts or Transactions Involving Interested Governing Persons or Officers" appears at TBOC section 101.255. Despite its title, the statute's plain language actually does not address conflicted transactions at all. In fact, it addresses everything about conflicted transactions except the transactions themselves. The section should be amended as soon as possible. The full section reads as follows:

> (a) This section applies only to a contract or transaction between a limited liability company and:
>
> (1) one or more of the company's governing persons or officers; or
>
> (2) an entity or other organization in which one or more of the company's governing persons or officers:
>
> (A) is a managerial official; or
>
> (B) has a financial interest.
>
> (b) An otherwise valid contract or transaction described by Subsection (a) is valid notwithstanding that the governing person or officer having the relationship or interest described by Subsection (a) is present at or participates in the meeting of the governing authority, or of a committee of the governing authority, that authorizes the contract or transaction or votes or signs, in the person's capacity as a governing person or committee member, a written consent of governing persons or committee members to authorize the contract or transaction, if:
>
> (1) the material facts as to the relationship or interest described by Subsection (a) and as to the contract or transaction are disclosed to or known by:
>
> (A) the company's governing authority or a committee of the governing authority and the governing authority or committee in good faith authorizes the contract or transaction by the approval of the majority of the disinterested governing persons or committee members, regardless of whether the disinterested governing persons or committee members constitute a quorum; or

(B) the members of the company, and the members in good faith approve the contract or transaction by vote of the members; or

(2) the contract or transaction is fair to the company when the contract or transaction is authorized, approved, or ratified by the governing authority, a committee of the governing authority, or the members of the company.

(c) Common or interested governing persons of a limited liability company may be included in determining the presence of a quorum at a meeting of the company's governing authority or of a committee of the governing authority that authorizes the contract or transaction.[5]

This section has a long history. The LLC provision is modeled on a similar provision in the corporate code (that I have commented on elsewhere).[6] Understanding it requires knowledge of the state of the common law prior to the statute's passage. Under the common law, a transaction involving a conflict of interest between a corporation and its director or officer was voidable by a shareholder.[7] The interested director or officer was held unable to act for the corporation.[8] The remainder of the board could act for the corporation,[9] the court reasoned, but because the interested director and the rest of the board were so closely related, the courts would subject the transaction to review for "inherent fairness" to ensure that the interested director took no "undue advantage."[10] The interested director or officer had the burden to show in court that the transaction was fair.[11] This remained the state of the law when the interested director statute was passed, in Texas, in 1985.[12]

When first passed, the corporate provision was written in the style of, and with language taken from, the Delaware corporate code.[13] The substantive language provided, "No contract or transaction between a corporation and one or more of its directors or officers ... shall be void or voidable solely for this reason ... if" certain corporate procedures are followed and those procedures meet certain substantive standards.[14]

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[5] TEX. BUS. ORGS. CODE ANN. § 101.255 (Vernon 2010).

[6] Val D. Ricks, *Texas' So-Called "Interested Directed" Statute*, 50 S. Tex. L. Rev. 129 (2008). The corporation provision is found at TEX. BUS. ORGS. CODE ANN. § 21.418 (Vernon 2010).

[7] Tenison v. Patton, 67 S.W. 92 (Tex. 1902); *see also* Ricks, *supra* note 6, at 154-57 (reporting the state of the law up until the passage of the first interested director statute in 1985).

[8] Tenison, 67 S.W. at 95.

[9] *Id.*

[10] *Id.* at 95-96.

[11] *Id.* at 96.

[12] *See* Ricks, *supra* note 6, at 137 n.33 & 154-57.

[13] Ricks, *supra* note 6, at 136 (the original statute passed in Texas had language nearly identical to the Delaware statute).

[14] Texas Business Corporations Act, 69th Leg., R.S., ch. 128, § 9, 1985 Tex. Gen. Laws 592, 597 (amended 1997) (current version at TEX. BUS. ORGS. CODE ANN. § 21.418 (Vernon 2010)). *Comp. id. with* Del. GEN. CORP. L. § 144.

Clearly, this statute aimed to define the effect of the conflict of interest itself. If the procedures and standards are met, then the conflict does not render the contract or transaction void or voidable. Delaware's statute still reads this way.[15]

After passage of the Delaware and Texas statutes, courts in Delaware construed this language so that, even if the procedures and standards were met, Delaware courts would still review the transaction in some limited respect.[16] Thus, Delaware courts were reviewing not only whether the procedures and standards were met, but the transaction itself. The statute was not the litigation-stopper that some in Texas hoped it would be.

The response of the Texas legislature was to modify the statute. The hope was to strengthen it. Whereas the original statute said that "[n]o contract or transaction [with a conflict of interest] shall be void or voidable solely for this reason," the new statute said, "An otherwise valid contract or transaction [with a conflict of interest] shall be valid notwithstanding that ...."[17] This sounds like a stronger approach if one stops reading there. But the statute fumbles and omits the most important part. Whereas the original statute said "void or voidable solely *for this reason*" (emphasis added), meaning by reason of the conflict, the new statute proclaims such a contract or transaction "valid notwithstanding that the director or officer ... is present at or participates in the meeting of the board of directors, ... or votes .... "[18] Nowhere does the statute say that the contract or transaction is valid notwithstanding the conflict itself. In fact, the conflict is not mentioned in the operative language of the statute. So the plainly restrictive clause "valid notwithstanding that" inoculates the contract or transaction against the presence or participation of the conflicted director at a board meeting.[19] And the clause saves the transaction from the actual voting of the conflicted director.[20] However, against the conflict itself, the statute does nothing. Because the statute no longer changes the effect of the common law on an interested transaction, the common law applicable to the transaction revives.[21] Under the common law, such transactions are once again voidable, and the interested director has the burden of proving in court that they are fair.[22]

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[15] DEL. GEN. CORP. L. § 144.

[16] These developments in Delaware corporate law are discussed in detail at Ricks, *supra*, note 6, at 136-40.

[17] TEX. BUS. ORGS. CODE ANN. art. 2.35-1 (Vernon 2003).

[18] TEX. BUS. ORGS. CODE ANN. § 21.418(b) (Vernon 2010).

[19] *Id.*

[20] *Id.*

[21] When a statute that supersedes the common law is repealed and not replaced, it is as if the statute never existed; the common law again applies. Nat'l Carloading Corp. v. Phoenix-El Paso Exp., 176 S.W.2d 564, 570 (Tex. 1944); Galveston, H. & H.R. Co. v. Anderson, 229 S.W. 998, 1001-02 (Tex. Civ. App.—Galveston 1920, writ ref'd); *See* Dickson v. Navarro County Levee Imp. Dist. No. 3, 139 S.W.2d 257, 259 (Tex. 1940); Phil H. Pierce Co. v. Watkins, 263 S.W. 905, 907 (Tex. 1924); Collins v. Warren, 63 Tex. 311 (1885); Goodrich v. Wallis, 143 S.W. 285, 286 (Tex. Civ. App.—Fort Worth 1911, no writ). Or, as phrased in other states' decisions, repeal of the statute revives the common law that preceded it. *See* Kelly v. Strange, 14 F.Cas. 273 (D.N.C. 1869); Wood v. Woods, 184 Cal.Rptr. 471, 477 (Cal.App. 1982); State v. Daley, 29 Conn. 272 (1860); Makin v. Mack, 336 A.2d 230, 234 (Del.Ch. 1975); Baum v. Thoms, 50 N.E. 357, 360 (Ind. 1898) (holding so even though a repeal of a statute did not revive a prior statute); State v. Buck, 275 N.W.2d 194, 197 (Iowa 1979); Harris v. State, 509 A.2d 120, 124 (Md. 1986); People v. Reeves, 528 N.W.2d 160, 164 (Mich. 1995); Hilton v. Thatcher, 88 P. 20, 22 (Utah 1906) (quoting 1 Lewis' Sutherland Stat. Const. 294).

[22] Tenison v. Patton, 67 S.W. 92 (Tex. 1902); *See* Ricks, *supra* note 6, at 137 n.33 & 154-57.

In this respect, the Texas statute stands alone. The prior statute and the statutes of all 49 other states limit the effect of the conflict.[23] Only Texas omits a reference to the conflict. So while the statute protects against the interested director's comparatively trivial participation at a meeting at which the transaction is approved, or the interested director's voting for the transaction, these gnats are spit out while the camel of the conflict itself is swallowed whole. And no one wants to swallow a camel.[24]

The corporate provision was copied into the LLC code, and changes made to the corporate provision over the years have likewise been copied into the LLC code.[25] But the problem has not been fixed in either, so as the code stands, a transaction involving a conflict between a LLC and its manager, officer, or a governing member is voidable unless proved fair, and the interested manager, officer, or member has the burden of proving fairness.

This problem is so easily fixed that letting it linger is inexcusable. The only change that needs to occur is that the phrase "the conflict described in subsection (a) or" be added after the word *notwithstanding* in subsection (b). Until then, the plain language of the statute renders the statute's title misleading and offers no help to business people seeking to avoid litigation over conflicted transactions. Delaware's statute would be more helpful.

II. TEXAS LLCS AND THE NEW THEORY OF AGENCY

Many years ago, the committee that drafts code for Texas business organizations provided the legislature with a statute that addressed the agents of limited liability companies.[26] This was a curious provision. No other business entity code addresses agents. In 2003, the committee that drafted the Texas Business Organizations Code provided the legislature with an updated statute.[27] The legislature passed the statute as written.[28] The code still contains this

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[23] *See* Ricks, *supra* note 6, at 134 & 134 nn. 17-21.

[24] Interestingly, and oddly, the statute was amended in 2009 to refer back to subsection (a) without fixing the problem. Prior to 2009, the statute said, "An otherwise valid contract or transaction is valid notwithstanding that ...." TEX. BUS. ORGS. CODE ANN. § 21.418(b) (Vernon 2007). As amended, the statute says, "An otherwise valid contract or transaction described by Subsection (a) is valid notwithstanding that ...." Tex. Bus. Orgs. Code Ann. § 21.418 (Vernon 2009). The change was pointless. No one could have doubted that subsection (b) in 2007 referred to the contract described in subsection (a). But the change fixed nothing. The otherwise valid contract or transaction described in subsection (a) is still not made valid notwithstanding the conflict itself; rather, it is only made valid notwithstanding the comparatively trivial presence or participation or voting of the interested director or officer.

[25] *Compare* TEX. BUS. ORGS. CODE ANN. § 101.255 (Vernon 2007) *and* TEX. BUS. ORGS. CODE ANN. § 101.255 (Vernon 2009), *with* TEX. BUS. ORGS. CODE ANN. § 21.418 (Vernon 2007) *and* TEX. BUS. ORGS. CODE ANN. § 21.418 (Vernon 2009).

[26] *See* Charles Szalkowski, Chairman's Letter, 28-JUN Bull. Bus. L. Sec. St. B. Tex. 1 (1991) (explaining that H.B. 278, part of which became the Texas Limited Liability Company Act; *See* Acts 1991, 72nd Leg., ch. 901, § 46, eff. Aug. 26, 1991; was drafted by the Business Law Section's Corporation Law Committee); Bill Analysis of H.B. 278 of the 72nd Leg., § 46 (1991) ("This article ... states a member is not a proper party to a proceeding by or against Limited Liability Company").

[27] *See* Revisor's Report on the Business Organization's Code, Title 3, available at http://www.texasbusinesslaw.org/committees/business-organizations-code/revisors-report-on-the-business-organizations-code/title-3.-limited-liability-companies/Title3.pdf/view, page 15. Despite the quite different language of the amended statute, the Revisor's Report states, "No substantive change is intended." *Id.*

[28] TEX. BUS. ORGS. CODE ANN. § 101.113 (Vernon 2010), Acts 2003, 78th Leg., ch. 182, § 1, eff. Jan. 1,

provision.

I was surprised to find this provision. It is not needed, and courts seem to have ignored it. To date, the common law of agency has provided that LLCs could be either principal or agent, the same as every other business entity.[29] A simple statement in a statute saying this result should hold might have codified the common law. What was passed does not codify the common law, but instead injects into agency law otherwise applicable to LLCs new concepts and rules different than the rules applicable to agents of other business structures. The statute also injects uncertainty into the law.

Try as I might, I cannot think of a good reason for any of these provisions. I recommend that the legislature amend the statute to omit references to common law agents. The TBOC says in another provision that "the powers of a [LLC] include the power to: ... elect or appoint ... agents of the entity."[30] That provision is sufficient.

This Part II first describes the application of the common law of agency. Possible effects of the statute are then examined. In short, the statute provides the following: (1) the statute abrogates limitations on actual and apparent authority; under the code, all agents of LLCs have as much authority as managers;[31] (2) a theory of liability, in addition to actual and apparent authority, is applied to LLCs, the contours of which are uncertain and potentially harmful;[32] and (3) apparent authority is no longer applicable to agents of LLCs.[33] I conclude with arguments for the recommended amendment.

A. The Common Law Applies to Texas LLCs, or Should Apply

The Texas LLC is a principal or agent under the common law, just as is any other principal or agent, and just as any other business entity or individual person.[34] The common law of agency is universally applied and, with respect to its principles, uncontroversial. An agency relationship exists when one agrees with another that he will act for the other and subject to the other's control.[35]

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[29] *See, e.g.*, Aquaduct, L.L.C. v. McElhenie, 116 S.W.3d 438, 441-42 (Tex. App.—Houston [14th Dist.] 2003, no pet.), and text *infra* Part II.A.

[30] TEX. BUS. ORGS. CODE ANN. § 2.101(14) (Vernon 2010); *see also* TEX. BUS. ORGS. CODE ANN. § 2.101(16) (Vernon 2010) (confirming a power to indemnify "agents of the entity").

[31] *See infra* Part II.B.1.

[32] *See infra* Part II.B.2.

[33] *See infra* Part II.B.3.

[34] *See* Aquaduct, 116 S.W.3d at 441-42 (holding on common law grounds that the LLC was the principle of an agent with implied actual authority), Plantation Prod. Props., L.L.C. v. Meeks, 10-02-00029-CV, 2004 WL 2005445 (Tex. App.—Waco Sept. 8, 2004, no pet.)(mem. op.) (employing common law agency principles to conclude that, though the purported agent lacked actual and apparent authority, the LLC had ratified the agency and was therefore bound by the contract). *See also* Bion Const., Inc. v. Grande Valley Homes, LLC, 2009 WL 4669844 (Tex. App.—San Antonio Dec. 9, 2009, no pet.)(mem. op.) (after passages of the TBOC but relying only on the common law of agency to resolve whether and LLC had conferred authority on an agent).

[35] *See* Orozco v. Sander, 824 S.W.2d 555, 556 (Tex. 1992); SITQ E.U., Inc. v. Reata Restaurants, Inc., 111 S.W.3d 638, 652 (Tex. App.—Fort Worth 2003, pet. denied); Royal Mortg. Corp. v. Montague, 41 S.W.3d 721, 732 (Tex. App.—Fort Worth 2001, no pet.); Commercial Escrow Co. v. Rockport Rebel, Inc., 778 S.W.2d 532, 539 (Tex.

With respect to contractual liability, "[a]bsent actual or apparent authority, an agent cannot bind a principal."[36] Actual authority depends on a principal's communication to the agent.[37] Actual authority means authority "intentionally conferred by the principal upon the agent, or such as the principal either intentionally allows the agent to believe that he possessed, or by want of ordinary care on the part of the principal, allows the agent to so believe."[38]

Apparent authority, on the other hand, is not actual authority but is a power to alter the legal relations of the principal. In Texas, apparent authority is related to estoppel.[39] It arises from a principal's manifestation of intent to a third party that another, the apparent agent, is authorized to represent the principal: "either from a principal knowingly permitting an agent to hold [himself] out as having authority or by a principal's actions which lack such ordinary care as to clothe an agent with the indicia of authority, thus leading a reasonably prudent person to believe that the agent has the authority [he] purports to exercise."[40] The third person must actually believe, reasonably, as a consequence of the principal's manifestation, that the "apparent agent" was authorized.[41] Thus, evidence of the principal's conduct, not the agent's, establishes apparent authority.[42] Declarations of the alleged agent, without more, do not establish apparent agency or the scope of the apparent agent's authority.[43] Finally, the principal must have

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App.—Corpus Christi 1989, writ denied); Tamburine v. Ctr. Sav. Ass'n, 583 S.W.2d 942, 948 (Tex. Civ. App.—Tyler 1979, writ ref'd n.r.e); Tarver Steele & Co. v. Pendleton Gin Co., 25 S.W.2d 156, 158 (Tex. Civ. App.—Eastland 1930, no writ); Bertrand v. Mut. Motor Co., 38 S.W.2d 417, 418 (Tex. Civ. App.—Eastland 1931, writ ref'd).

[36] Suarez v. Jordan, 35 S.W.3d 268, 272-73 (Tex. App.—Houston [14th Dist.] 2000, no pet.); Currey v. Lone Star Steel Co., 676 S.W.2d 205, 209 (Tex. App.—Fort Worth 1984, no writ).

[37] Gaines v. Kelly, 235 S.W.3d 179, 182 (Tex. 2007); *see* Thompson v. Schmitt, 274 S.W. 554, 557 (Tex. 1925) ("One who acts in my behalf, for my advantage, by my authority, is my agent.").

[38] Nat'l Cash Register Co. v. Wichita Frozen Food Lockers, 172 S.W.2d 781, 787 (Tex. Civ. App.—Fort Worth 1943), aff'd, 176 S.W.2d 161 (Tex. 1944). This is an oft-quoted statement. *See, e.g.*, Sanders v. Total Heat & Air, Inc., 248 S.W.3d 907, 913 (Tex. App.—Dallas 2008, no pet.); Lifshutz v. Lifshutz, 199 S.W.3d 9, 22 (Tex. App.—San Antonio 2006, pet. denied); Huynh v. Nguyen, 180 S.W.3d 608, 623 (Tex. App.—Houston [14th Dist.] 2005, no pet.); Park Cities Ltd. P'ship v. Transpo Funding Corp., 131 S.W.3d 654, 660 (Tex. App.—Dallas 2004, pet. denied); Aquaduct, L.L.C. v. McElhenie, 116 S.W.3d 438, 442 (Tex. App.—Houston [14th Dist.] 2003, no pet.); Suarez, 35 S.W.3d at 273; Disney Enters., Inc. v. Esprit Fin., Inc., 981 S.W.2d 25, 30 (Tex. App.—San Antonio 1998, pet. dism'd w.o.j.); Behring Intern., Inc. v. Greater Hous. Bank, 662 S.W.2d 642, 649 (Tex. App.—Houston [1st Dist.] 1983, writ dism'd by agr.).

[39] Gaines v. Kelly, 235 S.W.3d 179, 182 (Tex. 2007). Despite repeated assertions of apparent authority's ties to estoppel, the standard formulations do not contain a requirement that the third party suffer a detriment. *See, e.g., Gaines*, 235 S.W.3d at 182. The omission of this element leaves the true theory in some doubt. Is it based on the principal's manifestation of consent to the third party, or is it based on the need to protect the third party from harm? The omission of detriment as an element points to consent as the true ground. Estoppel, on the other hand, traditionally requires a detriment, and is intended to prevent unfairness to the third party. *See* David McDavid Nissan, Inc. v. Subaru of Am., Inc., 10 S.W.3d 56, 71 (Tex. App.—Dallas 1999) aff'd, 84 S.W.3d 212 (Tex. 2002). ("This doctrine applies where it would be unconscionable to allow a party to maintain a position inconsistent with one in which it acquiesced or from which it accepted a benefit."); Hotel Longview v. Pittman, 276 S.W.2d 915, 920 (Tex. Civ. App.—Texarkana 1955, writ ref'd n.r.e.) (requiring a showing of detriment to establish apparent agency based on estoppel).

[40] Gaines, 235 S.W.3d at 182; Ins. Co. of N. Am. v. Morris, 981 S.W.2d 667, 672 (Tex. 1998); NationsBank, N.A. v. Dilling, 922 S.W.2d 950, 952-53 (Tex. 1996).

[41] *See* Gaines, 235 S.W.3d at 182.

[42] *See* Gaines, 235 S.W.3d at 179, 182; NationsBank, N.A, 922 S.W.2d at 952.

[43] Gaines, 235 S.W.3d at 182.

full knowledge of all material facts regarding its manifestation.[44]

Both doctrines contain their own limitations. Both kinds of authority are limited by the content of the principal's manifestations. Actual authority is limited to that which is conferred on the agent by the principal.[45] Apparent authority is limited to "the scope of authority that is apparently authorized."[46]

These principles have always been applied to Texas LLCs, which courts claim can serve as agents or principals. In *Aquaduct, L.L.C. v. McElhenie* (2003),[47] the McElhenies signed a note in favor of a vendor.[48] The vendor later transferred the note to Aquaduct, L.L.C. Aquaduct appointed Gibraltar Mortgage as its servicing agent for the note. Later, when the McElhenies refinanced, they sent Gibraltar a partial pay-off of the note.[49] Gibraltar registered the pay-off as a deposit to the LLC's account but never paid the LLC. Later, when Aquaduct sued on the note, the McElhenies claimed Aquaduct had been paid. The issue was whether Gibraltar as servicing agent was authorized to receive a pay-off of the loan.[50]

The court treated the issue as a routine agency case. Citing the common law of agency, the court asked whether Gibraltar had actual or apparent authority to accept the partial pay-off on Aquaduct's behalf.[51] After reviewing the evidence, the court affirmed that Gibraltar had implied actual authority to accept the payment.[52] The court mentioned nothing unique about Aquaduct's status as a LLC. The court treated it as it would any other principal, whether business entity or natural person. No mention was made of the LLC's nature, and nothing appeared to depend on it.[53]

In *Beckham Resources, Inc. v. Mantle Resources, L.L.C.* (2010),[54] Beckham claimed that Mantle was Beckham's agent and had breached fiduciary duties. [55] The court relied on the common law test for agency to determine that Mantle was not Beckham's agent: "[W]e fail to see how either of these facts prove that Mantle was transacting business for Beckham or that Beckham was exercising control over or directing the actions of Mantle, which is the fundamental test of agency."[56]

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[44] *See* Gaines, 235 S.W.3d at 183-84; Sw. Title Ins. Co. v. Northland Bldg. Corp., 552 S.W.2d 425, 428 (Tex. 1977).

[45] *See* Ins. Co. of N. Am., 981 S.W.2d at 672.

[46] First Valley Bank of Los Fresnos v. Martin, 144 S.W.3d 466, 471 (Tex. 2004); Ins. Co. of N. Am. at 672-73; NationsBank, N.A. 922 S.W.2d,at 952.

[47] Aquaduct, 116 S.W.3d 438.

[48] *Id.* at 440.

[49] *Id.* at 441.

[50] *Id.*

[51] *Id.*

[52] Aquaduct, 116 S.W.3d at 441-42.

[53] *Id.* at 440-43.

[54] Beckham Res., Inc. v. Mantle Res., L.L.C., 13-09-00083-CV, 2010 WL 672880 (Tex. App.—Corpus Christi Feb. 25, 2010, pet. denied).

[55] *Id.* at *10.

[56] *Id.* at *12; *see also Id.* at *10-11.

The same common law of agency that applies to corporations applies to LLCs.[57] In *In re Credit Suisse First Boston Mortgage Capital, L.L.C.* (2008),[58] the court had to decide whether a jury trial waiver extended to a nonsignatory "on the basis of agency principles."[59] Both the alleged principal and the alleged agent in the case were LLCs. Citing the practical reality that "corporations can act only through [their] agents and employees,"[60] the court examined only the most common of agency principles: actual and apparent authority.[61] The court even referred to the two LLCs as "two corporations."[62] Clearly the court understood that the two types of entities are treated identically for purposes of agency issues.

In *Preferred Fuel Distributors v. Amidhara, LLC, et al.* (2010),[63] the plaintiff complained that agents of Panamerican, LLC, had committed fraud.[64] The court found evidence of a false statement made by Panamerican, LLC's president with respect to a transaction later memorialized in a contract that Panamerican's president signed for the LLC. The court did not discuss at length whether the LLC was responsible for the president's statements. Instead, it cited a few cases involving corporations that indicated the common law of agency would apply.[65] More directly, the court included in a parenthetical after one of those cases that "a principal may be vicariously liable for the fraudulent conduct of its agent if the agent acted with actual or apparent authority."[66] Apparently on this citation alone, the court reversed a summary judgment for Panamerican, LLC, and held it subject to trial along with its agent.[67]

The Texas common law of agency has thus been applied to LLCs as it has to other business entities and also to individuals. Nothing unique about the LLC has been recognized by Texas courts as calling for any special treatment. Yet, this is what the language of the statute demands.

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[57] *See, e.g.*, Sanchez v. Mulvaney, 274 S.W.3d 708, 712 (Tex. App.—San Antonio 2008, no pet.); *In re* Credit Suisse First Boston Mortg. Capital, L.L.C., 273 S.W.3d 843 (Tex. App. –Houston [14th Dist.] 2008, no pet.).

[58] *In re* Credit Suisse First Boston Mortgage Capital, L.L.C., 273 S.W.3d 843 (Tex. App.—Houston [14th Dist.] 2008, no pet.).

[59] *Id.* at 845.

[60] *Id.* at 849 (citing GTE Sw., Inc. v. Bruce, 998 S.W.2d 605, 618 (Tex. 1998)).

[61] *In re* Credit Suisse First Boston Mortgage Capital, L.L.C., 273 S.W.3d at 850.

[62] *Id.*; *see also* Sanchez, 274 S.W.3d at 712 (opining in a case dealing only with an LLC that a "corporation's agent is personally liable for his own fraudulent or tortious conduct, even when acting within the course and scope of his employment").

[63] Preferred Fuel Distribs., L.P. v. Amidhara, L.L.C., 10-08-00122-CV, 2010 WL 139308 (Tex. App.—Waco, Jan. 13, 2010, no pet.).

[64] *Id.* at *6.

[65] *Id.* at *7 (citing NationsBank v. Dilling, 922 S.W.2d 950 (Tex.1996), and Kingston v. Helm, 82 S.W.3d 755 (Tex. App.—Corpus Christi 2002, pet. denied)).

[66] *Id.* at *7 (citing NationsBank, 922 S.W.2d at 952-53).

[67] *Id.* at *9.

B. How the Statute Changes the Common Law

The statute now in the TBOC addressing agents of the LLC changes the common law. The statute reads as follows:

> (a) Except as provided by this title and Title 1, each governing person of a limited liability company and each officer or agent of a limited liability company vested with actual or apparent authority by the governing authority of the company is an agent of the company for purposes of carrying out the company's business.
>
> (b) An act committed by an agent of a limited liability company described by Subsection (a) for the purpose of apparently carrying out the ordinary course of business of the company, including the execution of an instrument, document, mortgage, or conveyance in the name of the company, binds the company unless:
>
> (1) the agent does not have actual authority to act for the company; and
>
> (2) the person with whom the agent is dealing has knowledge of the agent's lack of actual authority.
>
> (c) An act committed by an agent of a limited liability company described by Subsection (a) that is not apparently for carrying out the ordinary course of business of the company binds the company only if the act is authorized in accordance with this title.[68]

The difficulties the statute creates are catalogued in the sections that follow, which describe each subsection specifically.

i. Subsection (a): Delimiting Authority

The statute's message for agents in subsection (a) can be clarified if the language about only governing persons and officers of LLCs is discarded. Then section (a) of the statute reads as follows:

> (a) ... [E]ach ... agent of a limited liability company vested with actual or apparent authority by the governing authority of the company is an agent of the company for purposes of carrying out the company's business.

[68] TEX. BUS. ORGS. CODE ANN. §101.254 (Vernon 2011).

What could be the purpose of such a provision? The language of the statute broadens the scope of each agent's authority. Under the common law, an agent vested with actual authority by an LLC's governing authority is an agent for purposes of carrying out that actual authority. The agent's authority is limited to what is authorized.[69] Thus, the LLC's real estate agent is empowered to look for property for the LLC, but not to sign a contract, execute a mortgage, or direct the employees. The LLC's lawyer is also supposed to have a limited role. So are the common employees. They may even drive the pizza delivery vehicle and be servants (which are a subset of agents[70]) able to bind the LLC to tort liability. No one with common sense would suppose such persons to have broad authority within the business.

The statute describes their authority much more broadly. According to the statute's language, each such agent is "an agent of the company for purposes of carrying out the company's business." "[T]he company's business" is as broad as the business is broad. Agency limited only by that purpose includes everything the LLC does within the scope of its general powers[71] and the purpose designated in its certificate of formation,[72] which could include "any lawful purpose" for an LLC.[73] If this is the meaning of the clause, then appointing an agent is a dangerous act. Giving any agent actual authority makes them the LLC's agent for all of the company's business, just as any manager! Why else would the statute use the same language to describe both the authority of managers and the authority of all other agents? Creating apparent authority is even more hazardous. A person does not even need to be an agent to carry

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[69] Ins. Co. of N. Am., 981 S.W.2d at 672.

[70] *See* Am. Nat. Ins. Co. v. Denke, 95 S.W.2d 370, 372-73 (Tex. Comm'n 1936) (adopting as law the following language from the Comment (a) to Section 250 of the Restatement of the Law of Agency: "It is only when to the relationship of principal and agent there is added that right to control physical details as to the manner of performance which is characteristic of the relationship of master and servant, that the person in whose service the act is done becomes subject to liability for the physical conduct of the actor"); Stapp Drilling Co. v. Roberts, 471 S.W.2d 131, 134 (Tex. Civ. App.—Corpus Christi 1971, writ ref'd n.r.e.) (same as *Denke*); Graham v. McCord, 384 S.W.2d 897, 898-99 (Tex. Civ. App.—San Antonio 1964, no writ) (same as *Denke*); Sartain v. S. Nat. Life Ins. Co., 364 S.W.2d 245, 250 (Tex. Civ. App.—Austin 1962, writ ref'd n.r.e.) (same as *Denke*); Walter Irvin, Inc. v. Vogel, 158 S.W.2d 93, 96-97 (Tex. Civ. App.—Amarillo 1942, writ ref'd w.o.m.) ("The true test in all of the cases on this question seems to be that in order to hold the principal liable it is not sufficient that he be interested only in the ultimate results to be accomplished by his representative, but he must also have the right to control the *physical details as to the manner of the performance* of the work."); Am. Nat. Ins. Co. v. Kennedy, 101 S.W.2d 825, 827-28 (Tex. Civ. App. 1937) *modified*, 107 S.W.2d 364 (Tex. 1937) (same as *Denke*). In other words, a servant is an agent subject also to the principal's control with regard to the physical details of the manner of performance. *But see* Ackley v. State, 592 S.W.2d 606, 608 (Tex. Crim. App. 1980) (stating in dicta that an agent is employed for contractual dealings but a servant is not, and generally treating them as different categories). *Ackley* cited as authority for this distinction Gibson v. Gillette Motor Transp., 138 S.W.2d 293, 294 (Tex. Civ. App.—Eastland 1940, writ ref'd). *Gibson* does not make an explicit distinction between agent and servant. *Ackley* was apparently trying to make sense of the following two sentences from *Gibson*: " There was no evidence to show that Miller was an agent. The evidence does show that Miller was an employee and that his duties were such as to make him a servant." *Id.* If a servant is an agent, the sentences must be incorrect. I suggest that the *Gibson* court meant to suggest that Miller had no actual authority. A servant needs no actual authority to bind its master to tort liability, however. There is also an old line of cases regarding workers' compensation that in defining *independent contractor* talks in dicta as if principal and agent and master and servant are separate categories. *Century Indem. Co. v. Carnes*, 138 S.W.2d 555, 556 (Tex. Civ. App.—Fort Worth 1940, writ dism'd judgm't cor.), is typical.

[71] *See* TEX. BUS. ORGS. CODE ANN. § 2.101 (Vernon 2011) .

[72] *See* TEX. BUS. ORGS. CODE ANN. § 3.005(a)(3) (Vernon 2011).

[73] *Id.*

apparent authority.[74] Thus, the statute may have the effect of making someone who would otherwise not be an agent at all an agent for all of the LLC's business!

This would be an unfortunate effect, but that appears to be the language's meaning. The language is borrowed from the general partnership code, which has long provided that "[e]ach partner is an agent of the partnership for the purpose of its business."[75] With regard to a general partner, such a provision is justified in part because "[e]ach partner has equal rights in the management and conduct of the business of a partnership."[76] Each partner is thus a principal in the business—a manager. That is why each general partner is appropriately designated by the code as a "governing person."[77] A general partner is also an owner of the general partnership.[78] As owner, principal, and manager, a general partner is a general agent for purposes of the partnership's business—in fact, under agency principles, the general partner has power to designate herself as such. Thus, the language in the partnership code correctly designates each partner "an agent of the partnership for the purpose of its business." [79] This language means that, "[a]s a general rule, each partner ... is empowered to bind the partnership in the normal conduct of its business."[80] This conclusion follows from the partner's position as owner and manager of the general partnership. This result is consistent with the common law of agency.[81]

In the LLC context, the "purpose of its business" language has been construed to mean something similar to its meaning in the partnership code with respect to a manager of a LLC. In *EZ Auto, L.L.C. v. H.M. Jr. Auto Sales*,[82] the initial manager of EZ Auto, Marks, bought four cars from H.M. Auto Sales (H.M.).[83] When the draft written to pay for the third car was returned unpaid, Marks explained that EZ was having trouble with its bank account and offered a personal check.[84] Marks also paid for the fourth vehicle with a personal check, essentially a loan by Marks to EZ.[85] The title to this fourth vehicle was transferred to EZ, and

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[74] A person with apparent authority need not be an agent because nothing in the doctrine of apparent authority requires that the so-called "apparent agent" act on the principal's behalf and subject to its control.

[75] TEX. BUS. ORGS. CODE ANN. § 152.301 (Vernon 2011). TEX. BUS. ORGS. CODE ANN. § 152.301 (Vernon 2011); *see, e.g.*, Vernon's Ann.Tex. Civ.St. Art. 6132b, § 9 (1962); *see also* Uniform Partnership Act § 9 (1914) ("Every partner is an agent of the partnership for the purpose of its business.").

[76] TEX. BUS. ORGS. CODE ANN. § 152.203(a) (Vernon 2011).

[77] *See id.* § 1.002(35)(A) & §1.002(37).

[78] *See id.* § 152.051(b).

[79] *See id.* § 152.301.

[80] Long v. Lopez, 115 S.W.3d 221, 226 (Tex. App.—Fort Worth 2003, no pet.) (citing Texas Revised Uniform Partnership Act Art. 6132b-3.02(a)); *see also* In re Hawthorne Townhomes, L.P., 282 S.W.3d 131, 139 (Tex. App.—Dallas 2009, no pet.) (finding on this same language that the general partner of a limited partnership was the agent of the partners).

[81] Cook v. Brundidge, Fountain, Elliott & Churchill, 533 S.W.2d 751, 757-58 (Tex. 1976) (resting on both the statutory language and the common law to determine that "[t]he extent of authority of a partner is determined essentially by the same principles as those measuring the scope of the authority of an agent").

[82] EZ Auto, L.L.C. v. H.M. Jr. Auto Sales, 2002 WL 1758315, Opinion (Tex. Civ. App.—San Antonio, July 31, 2002).

[83] *Id.* at *1.

[84] *Id.*

[85] *Id.* at *2.

later EZ sold the vehicle to a third party.[86] After Marks's last check was returned unpaid for insufficient funds, H.M. sued EZ for the price of the car. At issue was whether Marks was the agent of EZ.

The court initially cited common law principles of actual and apparent authority.[87] The rule it followed, however, was the predecessor to TBOC § 101.254, which said that "each manager of a limited liability company whose management is vested in managers is an agent of the limited liability company for purposes of its business."[88] The court noted also that EZ's articles of organization provided that "'any one manager may act on behalf of EZ."[89] On these grounds, the court concluded that Marks as manager had actual authority.[90] Either the statute, on the one hand, or the articles of organization and the common law of agency, on the other, support such a conclusion. The court seemed to see no difference resulting from applying either. Both independently show that Marks had actual authority to act for the LLC in the conduct of its business. The language in the code specifies the authority of a manager.

That is why using the same language to describe the authority of all agents or "apparent agents" of a LLC is such a serious problem. Should this language apply to a non-partner, non-manager agent? Should each real estate agent, lawyer, and pizza delivery driver hired by an LLC have the authority of a LLC manager? Surely not. Moreover, there is no reason in fact or law to deprive the LLC's management of the capacity to appoint an agent with limited authority, nor does a need exist to say that, if an agent is apparently authorized for a single purpose, it is authorized for all purposes. Yet the statute says flatly that an agent or apparent agent is an agent of the LLC "for purposes of carrying out the company's business,"[91] just as if each such agent or apparent agent was a manager of the LLC.

Perhaps all is not lost. The TBOC recognizes that its default provisions might not be for everyone and allows them to be superseded by agreement of the LLC members.[92] On the other hand, in the absence of agreement, the code provisions apply,[93] so agents' authority will have to be limited by affirmative agreement, a tedious chore that would be unnecessary if common law agents had not been included in this provision. Furthermore, it is not clear why (or whether) an agreement of the LLC members should be able to supersede the authority of an apparent agent. Allowing an agreement between LLC members to limit the authority of an apparent agent essentially allows principals of an LLC to mislead third parties with impunity. On the other hand, the authority named in subsection (a) is not apparent but actual authority, so perhaps this does not matter (the rest of section 101.254 probably abrogates apparent authority, anyway[94]).

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[86] *Id.* at *2

[87] EZ Auto, L.L.C., at *2-3.

[88] Texas Limited Liability Company Act, Art. 1528n, art. 2.21B (Vernon 1997).

[89] EZ Auto, L.L.C., at *3.

[90] *Id.*

[91] TEX. BUS. ORGS. CODE ANN. § 101.254(a) (Vernon 2010).

[92] *See id.* § 101.052.

[93] *See id.* § 101.052(b).

[94] *See infra* Parts II.B.2 & II.B.3.

If giving all agents the authority of a manager is not what the code drafters were trying to do, I confess to ignorance as to why they used language that appears to reach that result. I have only been able to think of one other possible reason for lumping all agents in with others such as managers who are clearly general agents of the LLC for its broad business purposes. Perhaps the drafters meant merely to define a term *agent* for purposes of subsections (b) and (c). Both subsections (b) and (c) begin with a reference to "an agent ... described in Subsection (a)."[95] Some definition was necessary. The difficulty with this rationale is that subsection (a) could perform this function without its final clause that empowers agents so broadly: "for purposes of carrying out the company's business." If that clause were omitted from (a), subsection (a) would then say, merely, "[E]ach ... agent of a limited liability company vested with actual or apparent authority ... is an agent of the company."[96] This would be tautological in the case of actual agents, but the definitional function of subsection (a) would be clear, as no language in subsection (a) would have any other substantive effect than to define the word *agent* as used technically in the rest of the statute. Unfortunately, this rationale therefore renders the final clause of subsection (a) superfluous, and is not a plausible construction of the statute. Subsection (a) appears to have the effect outlined above: all agents, including apparent agents, have authority equal to that of a manager.

ii. Subsection (b): A Third Theory of Authority (and NOT a Useful One)

Section (b) follows. Please consider while reading it that it applies to common agents of a LLC and also those who have only apparent authority.

> (b) An act committed by an agent of a limited liability company described by Subsection (a) for the purpose of apparently carrying out the ordinary course of business of the company, including the execution of an instrument, document, mortgage, or conveyance in the name of the company, binds the company unless:
>
> (1) the agent does not have actual authority to act for the company; and
>
> (2) the person with whom the agent is dealing has knowledge of the agent's lack of actual authority.[97]

Describing the meaning of this odd provision requires some explanation. First, it is clear that this provision is not a codification of, and in fact has nothing to do with, apparent authority. As stated earlier, apparent authority arises from the principal's manifestations of intent to a third party that a person is authorized as the principal's agent. [98] The third person must actually believe, reasonably, as a consequence of the principal's manifestation, that the "apparent agent" was authorized.[99]

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[95] TEX. BUS. ORGS. CODE ANN. § 101.254(b) & (c) (Vernon 2010).

[96] *See id.* § 101.254(a).

[97] *See id.* § 101.254(b).

[98] Gaines, 235 S.W.3d at182; Ins. Co. of N. Am., 981 S.W.2d at 672; NationsBank, N.A., 922 S.W.2d at 952-53.

[99] Gaines, 235 S.W.3d at 182.

This section is inconsistent with apparent authority in several ways. Authority under the statute is established without a showing that anyone—governing person, manager, member—made a manifestation. Nor does the statute require that the third party form a reasonable belief. In fact, the third party's belief is not relevant at all under the statute. It is possible, in fact, that the third party unreasonably believe that the agent is authorized, and the section might still apply to give that agent authority, as long as the requisite act occurred. All that need be shown is that a person named in subsection (a) did an act that fits the description in (b). As long as the third party did not know—not merely believe, reasonably or unreasonably—that the agent was not authorized, the agent will still have authority under the statute even if it lacked actual authority. Clearly what the statute describes is not apparent authority.

If that were not clear enough, the mere presence of element (2) in the exception to subsection (b) also proves that what the section describes is not apparent authority. For apparent authority to exist, the third person must actually believe that the "apparent agent" is authorized, so no apparent authority could exist if (b)(2) applied. The language of (b)(2) negates apparent authority. Thus, if what section (2) described was apparent authority, no one could ever get to (b)(2). Section (b)(2) would be superfluous. Section (b) would only apply if that kind of knowledge were absent. The presence of (b)(2) thus proves that subsection (b) does not describe apparent authority.

Stated another way, an exception cannot entirely negate that to which it is an exception. If it did, then it would not be an exception but a part of the general rule. If the theory of subsection (b) is apparent authority, then that theory is fully stated in the words "for the purposes of apparently carrying out the ordinary course of business of the company." Nothing more could be needed to say it, as those are all the relevant words available in the subsection. Clause (b)(2) is phrased as an exception, but in fact the knowledge of the third person that an "apparent agent" is not authorized would mean that no apparent authority existed. If the third person knew such a thing, there would be no apparent authority left for which clause (b)(2) could be an exception. It follows that section (b) is not talking about apparent authority.

If subsection (b)'s theory is not apparent authority, then what is it? Section (b) actually extends to the agents of LLCs a theory of agency found in the general partnership code, which is (as it was for subsection (a)) the source of this language. The partnership code provides,

> Unless a partner does not have authority to act for the partnership in a particular matter and the person with whom the partner is dealing knows that the partner lacks authority, an act of a partner, including the execution of an instrument in the partnership name, binds the partnership if the act is apparently for carrying on in the ordinary course: (1) the partnership business; or (2) business of the kind carried on by the partnership.[100]

Here as well, and for the same reasons, this clause cannot logically purport to bind partnerships under the common law doctrine of apparent authority. Instead, this language is, like the lan-

[100] TEX. BUS. ORGS. CODE ANN. § 152.302(a) (Vernon 2010).

guage similar to that in subsection (a), meant to take account of a general partner's particular status as owner, manager, and principal of a partnership. Such a manager and general agent of a partnership has power herself to determine the scope of the partnership's business and to appoint agents to carry it forward. Such an agent's power need not be tied to the reasonable belief of the third party. Thus, when a Texas Court of Appeals looked at this corresponding partnership code provision, in *Burns v. Gonzalez*,[101] though the court talked a bit about apparent authority, the court concluded that the "apparently for carrying on" language required a look not at what the principal had done, or what the other party to the transaction reasonably or unreasonably thought, but at what was apparent to the court, or a disinterested onlooker.[102] That is a reasonable construction of a statute that is not simply a codification of the doctrine of apparent authority.[103]

The theory described in section 101.254(b), like the one espoused in *Burns*, does not mention the principal at all, nor does it depend on the principal holding out the agent as having authority. Nor does it require the reasonable belief of a third party. Instead, liability appears to depend on the circumstances of the business and the transaction, something quite beyond the governing authority's control and beyond the needs of the third party. It is not actual authority, and it is not apparent authority. It threatens to reach beyond what the LLC can control. It also applies even when an ignorant third party unreasonably believes that an agent is authorized, thus rewarding ignorance. Whatever reasons may support its existence for partners, or perhaps for LLC managers and officers, it should not be allowed to displace the common law of agency that the courts, quite rightly as a matter of policy, believe apply to LLCs.

iii. Subsection (c): The End of the Common Law of Agency for LLCs

Whereas subsection (b) attempts to promulgate an additional theory of liability for businesses, in addition to the common law of agency, subsection (c) attempts to limit the law of agency to only two theories: that found in (b) and a theory of actual authority named in the statute. Subsection (c) states:

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[101] Burns v. Gonzalez, 439 S.W.2d 128 (Tex. Civ. App.—San Antonio 1969, writ ref'd n.r.e.).

[102] *Id.* at 132-34. In *Burns*, a partnership had signed a contract conveying to a third party a right to broadcast time on a radio station. The partnership's sole business was selling broadcast time on that single radio station. *Id.* at 129. When the station went off the air for several months, the partners tried to settle with disgruntled advertisers. *Id.* at 130. Burns was a disgruntled advertiser. One of the partners, Bosquez, signed a note to Burns for $20,000 to compensate Burns for the deprivation of broadcast time. *Id.* Settling with disgruntled advertisers seems like just the thing a partnership devoted to selling advertising on a radio station would do if the station went off the air. But the court never asked whether Burns reasonably thought Bosquez by virtue of his position as a partner was apparently authorized to sign the note. *Id.* at 132-34. Instead, it asked whether partnerships generally engaged in selling ad time on the radio regularly signed notes, like "trading partnerships." *Id.* Of course, they did not, and Burns was unable to recover. I am indebted to Professor Gary Rosin for calling *Burns* to my attention.

[103] The Texas Supreme Court looked at this provision later, in *Cook*, 533 S.W.2d at 758, and said, after citing *Burns*, "The extent of authority of a partner is determined essentially by the same principles as those measuring the scope of the authority of an agent." *Id.* at 758 (reciting section 9 of the Uniform Partnership Act (1914), which was Texas law at the time and was the pattern for TBOC § 152.302(a)). The court never noted the illogic of that statement as a construction of the statute, which it had just cited. To make matters worse, the *Cook* court found that the partner at issue had no authority under either theory, *id.* at 758-59, so the statement is essentially dicta. This area of the law is not fully consistent with applicable statutes.

> (c) An act committed by an agent of a limited liability company described by Subsection (a) that is not apparently for carrying out the ordinary course of business of the company binds the company only if the act is authorized in accordance with this title.[104]

The obvious effect of this section is to limit liability to subsection (b) and the theory of actual authority set out in subsection (c). The language "that is not apparently for carrying out the ordinary course of business of the company" is an obvious reference to subsection (b). The section sets out only two alternatives. An act not binding under subsection (b) is binding "only if" it is authorized in accordance with Title 3, which contains provisions addressing only limited liability companies. Thus, subsection (c) limits liability to two theories: that in subsection (b) and actual authority. Because the theory set forth in subsection (b) is not apparent authority, subsection (c) requires that the theory of apparent authority be abandoned in the LLC context. LLCs are not bound by apparent authority.

This seems at first a very odd result, especially since subsection (a) refers to agents "vested with ... apparent authority."[105] However, at least the statute is consistent. Subsection (a) in fact says of agents vested with apparent authority that each is in fact "an agent of the company for purposes of carrying out the company's business."[106] Subsection (a) thus also discards the doctrine of apparent authority, with its limitations, and instead empowers "apparent agents" with actual authority broadly to carry out the company's business, as discussed previously.[107] Since subsection (a) replaces the apparent authority of "apparent agents" with a broader grant of actual authority, the doctrine of apparent authority is unnecessary to bind a LLC.

Subsection (c) on its face has other, broader consequences, however. As discussed previously, servants are agents.[108] If subsection (c) limits the liability of the LLC to the theory in subsection (b) and actual authority, liability under respondeat superior is also abrogated. I think that would be a ludicrous result, and I seriously doubt any Texas court would reach that conclusion, but when the language of the statute plainly reaches it, and a court in order to reach a sensible result has to depart from the statute's plain language, it is evidence that the statute needs to be reworked.

C. If Agents Were Omitted

To resolve the foregoing difficulties, I recommend omitting agents from section 101.254. Merely removing the phrase "or agent" from section 101.254(a) would have the desired effect. The statute would no longer displace agency law, and agents of LLCs would go back to being treated like agents of other business entities.

The section would still not be perfect. One would have to explain why managers and

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[104] TEX. BUS. ORGS. CODE ANN. § 101.254(c) (Vernon 2010).

[105] *See id.* § 101.254(a).

[106] *Id.*

[107] *See supra* Part II.A.

[108] *See supra* note 70.

officers of LLCs could not be liable under apparent authority, but the statute would cause no more potential confusion in that regard than the statute applicable to partners, section 152.302, as explained above, which also adopts liability for "apparently ... carrying on," a theory that appears to depart from the common law's doctrine of apparent authority.[109] Resolving that confusion further in the LLC and partnership codes might require more amending. But at least agents should be cut out and sent back to the common law of agency.

III. VEIL PIERCING

The LLC code seems quite clear on the issue of members' liability for the obligations of the LLC:

> Except as and to the extent the company agreement specifically provides otherwise, a member or manager is not liable for a debt, obligation, or liability of a limited liability company ....[110]

This section does not protect individuals acting within or for a LLC from their own individual liability.[111] Rather, this sentence holds merely that the liability of the LLC will not be placed on a member or manager. This seemingly simple sentence does not tell the whole story, though. The corporate code has long provided that shareholders also are not liable for the debts and obligations of corporations, and that has not stopped courts from "piercing the corporate veil" and imposing corporate liability on shareholders notwithstanding.[112] Courts have held that an LLC's veil can also be pierced.[113]

A variety of rationales support imposing, in appropriate circumstances, entity liability on those who control the entity. I have two favorite rationales, for which I have never heard good counter-arguments. First of all, a rule should not be construed to reach absurd results.[114] When a person controlling a limited liability entity places liability exclusively in the entity in order to enable the controller to commit a fraud, the rule shielding the controller from that liability is absurd and should be discarded. The Texas Supreme Court recently affirmed this rationale for veil piercing when it listed the "kinds of abuse ... that the corporate structure should

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[109] *See supra* Part II.B.

[110] TEX. BUS. ORGS. CODE ANN. § 101.114 (Vernon 2010).

[111] Sanchez, 274 S.W.3d at 712 ("The issue of a defendant's liability in his individual capacity is distinct from that of his liability under an alter ego theory."); *see also* Miller v. Keyser, 90 S.W.3d 712, 717 (Tex. 2002) ("[A] corporate agent is personally liable for his own fraudulent or tortious acts.").

[112] *See, e.g.*, Robert W. Hamilton, Elizabeth S. Miller & Robert A. Ragazzo, 20 Texas Practice Series § 26.11 et seq. (2004).

[113] *See, e.g.*, *id.* at § 20.7; *infra* note 119.

[114] *See* Witherspoon v. Jernigan, 76 S.W. 445, 447 (Tex. 1903) ("When a literal interpretation of the language used would produce an absurdity, the court will restrict or enlarge the text so as to conform to the general purposes and intent of the Legislature."); Korndorffer v. Baker, 976 S.W.2d 696, 700 (Tex. App.—Houston [1st Dist.] 1997, pet. dism'd w.o.j.) ("[W]here the application of the statute's plain language would lead to absurd consequences that the legislature could not have possibly intended, we will not apply the statutory language literally."); *see also, e.g.*, Sharp v. House of Lloyd, Inc., 815 S.W.2d 245, 249 (Tex. 1991); *see also, e.g.*, V.T.C.A., Government Code § 311.021 (2010) ("In enacting a statute, it is presumed that ... a just and reasonable result is intended."), made applicable to TBOC § 101.113 by TBOC § 1.051 (2010).

not shield."[115] The first item on the list was "fraud."[116]

Second, business entities may convey away assets in exchange for less than reasonably equivalent value. This is the kind of activity that fraudulent transfer laws[117] are supposed to stop, but those laws may not work very well against certain business entities. These entities cannot be put on the stand and cross-examined. They are only what their controllers make of them. Their controllers keep records, or they do not. If no or inadequate records exist, then proving that a conveyance occurred at all could be difficult, and the details of numerous fraudulent conveyances may be lost. Assets may be moved, business opportunities shifted to new entities with the same or similar owners, taxes paid or not, costs and employees paid by one entity or the other, and so on—and all potential evidence of wrongdoing is in the hands of the person controlling the entity, and that person has caused no documentation to be made. At some point, it is fair to hold that person liable for the entity's liability because the alternative would be that the person's sloppiness and negligence (or perhaps intent to hide wrongdoing) would place the entities themselves entirely beyond the law. Small wonder that the Texas Supreme Court listed next after fraud, in its list of abuses that the corporate veil should not shield, "evasion of existing obligations."[118]

The chapter of the TBOC that contains provisions that apply to LLCs does not itself mention veil piercing doctrines, or anything other than the shield law cited at the beginning of this section. However, Texas courts have agreed that veil piercing doctrine applies against LLC members.[119] Inasmuch as any rule could have absurd applications and actually shield fraudulent conduct, and inasmuch as the LLC form could be abused as much as the corporate form, application of some veil piercing doctrine against certain LLC members and managers makes sense.

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[115] SSP Partners v. Gladstrong Invs. (USA) Corp., 275 S.W.3d 444, 455 (Tex. 2008).

[116] *Id.* at 455; *Id.* at 451 ("Examples are when the corporate structure has been abused to perpetrate a fraud ....").

[117] *See, e.g.*, V.T.C.A., Bus. & C. T. 3, Ch. 24 (2010) (Uniform Fraudulent Transfer Act).

[118] SSP Partners, 275 S.W. 3d at 455; *id.* at 451 ("Examples are when the corporate structure has been abused to ... evade an existing obligation ...."). Potential other abuses that the Texas Supreme Court cited to justify imposing liability on shareholders involve shareholders more directly: "circumvention of statutes, monopolization, criminal conduct." *Id.* at 455; *id.* at 451 ("achieve or perpetrate a monopoly, circumvent a statute, protect a crime, or justify wrong").

[119] *In re* Hous. Drywall, Inc., 05-95161-H4-7, 2008 WL 2754526, *32 (Bankr. S.D. Tex., July 10, 2008) (holding that a limited partnership and its general partner, an LLC, were a "sham corporation" and unable to shield the individual controlling them from personal liability); Bramante v. McClain, Sr., CIVA SA-06-CA-0010 O, 2007 WL 4555943 (W.D. Tex. Dec. 18, 2007) (allowing a reverse veil piercing action to continue against an LLC and its owners); DDH Aviation, L.L.C. v. Holly, CIV .A3:02-CV-2598-P, 2005 WL 770595, **5-8, (N.D. Tex. Mar. 31, 2005) (allowing an alter ego claim against a LLC); In re Moore, 379 B.R. 284, 284 et seq. & 289 n.4 (Bankr. N.D. Tex. 2007) ("The court believes that whether a business enterprise is an LLC or a corporation is a distinction without a difference in this context."); *In re* JNS Aviation, LLC, 376 B.R. 500, 525-31 (Bankr.N.D.Tex. 2007); Watkins v. Basurto, 2011 WL 1414135 (Tex. App.—Houston [14th Dist.] Apr. 14, 2011); Genssler v. Harris Cty., ___ S.W.3d ___, 2010 WL 3928550 ((Tex. App.—Houston [1st Dist.] Oct. 7, 2010); Phillips v. B.R. Brick and Masonry, Inc., 01-09-00311-CV, 2010 WL 3564820 (Tex. App.—Houston [1st Dist.] Sept. 10, 2010, no pet.); Sanchez, 274 S.W.3d at 712; McCarthy v. Wani Venture, A.S., 251 S.W.3d 573 (Tex. App.—Houston [1st Dist.] 2007, pet. denied); Pinebrook Props., Ltd. v. Brookhaven Lake Prop. Owners Ass'n, 77 S.W.3d 487 (Tex. App.—Texarkana 2002, pet. denied) (dicta).

Just what veil piercing doctrine to apply is another matter.[120] Thus far, courts have imposed on LLC managers and members the same doctrines applicable to corporations.[121] This is somewhat problematic in Texas, however. In Texas, the legislature in response to some loose language in a decision by the Texas Supreme Court in 1986, *Castleberry v. Branscum*,[122] changed the common law's doctrine of veil piercing.[123] The statute passed in 1989 and amended in 1993 has a long and well-told history.[124] The statute was in fact poorly drafted and has been the source of controversy in judicial decisions since its passage,[125] as I discuss *infra*. My purpose is not to ask that it be re-drafted (though that is surely a good idea), but to ask whether it should be imposed on LLCs, too.

The answer to that question, thus far, appears to have been ... why not? The law has not progressed beyond asking that question. One thing the statute requires, in order to impose a contractual liability on shareholders, is a finding of actual fraud.[126] In the leading case, *McCarthy v. Wani Venture, A.S.*,[127] the trial court assumed the statute applied and presented the case to the jury on that assumption.[128] The jury found what the statute requires—actual fraud—and this was supported by the evidence.[129] The existence of actual fraud obviated the need to say whether application of the statute was really necessary. In *Sanchez v. Mulvaney*,[130] the court turned liability aside for failure to prove actual fraud, but this is because the entity was, the court said, a "limited liability corporation to which state law principles for piercing the corporate veil apply."[131] The court failed to explain why a limited liability company is a corporation.

The courts are not alone. Professor Miller claims, speaking of the developments in *McCarthy* and *Sanchez*, "there is nothing to preclude a court from defining the standards in the LLC context consistently with the corporate statutes in Texas when defining how veil piercing should apply to LLCs as a matter of Texas common law."[132] On policy, she reaches the same conclusion: "there does not appear to be any reason for the courts, when developing the Texas common law of LLC veil piercing, to adopt standards that explicitly provide less liability pro-

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[120] The difficulty I describe here was also named in Elizabeth S. Miller, *Are There Limits on Limited Liability? Owner Liability Protection and Piercing the Veil of Texas Business Entities*, 43 Tex. J. Bus. L. 405, 416-26 (2009); Natalie Smeltzer, *Piercing the Veil of a Texas Limited Liability Company: How Limited Is Member Liability?*, 61 SMU L. Rev. 1663 (2008).

[121] *See supra* cases cited note 119. To its credit, *Watkins*, 2011 WL 1414135, *8 n.15, reserves the question.

[122] Castleberry v. Branscum, 721 S.W.2d 270 (Tex. 1986), *superseded in part by statute*, TEX. BUS. ORGS. CODE ANN. § 21.223 (Vernon 2010) (formerly Texas Business Corporations Act Art. 2.21).

[123] *See* Hamilton, Miller & Ragazzo, *supra* note 112, at § 26.16 et seq.

[124] *See id.* at § 26.11 et seq.

[125] *See, e.g., id.* at § 26.16 to 26.23.

[126] TEX. BUS. ORGS. CODE ANN. § 21.223(a)(2) & (b) (Vernon 2010).

[127] McCarthy, 251 S.W.3d 573.

[128] *Id.* at 591.

[129] *Id.*

[130] Sanchez, 274 S.W.3d 708.

[131] *Id.* at 712.

[132] Miller, *supra* note 120, at 417; *see also* Hamilton, Miller & Ragazzo, supra note 112, at § 20.7 ("there is no apparent policy reason not to apply consistent standards"; "the standard set by [the corporate provision] ... would be appropriate in the context of LLCs").

tection for an LLC member than that available to a corporate shareholder."[133] But she provides no reasons why the statute should be imposed on LLCs and their members. For my part, I wish to suggest three reasons why not to impose this statute outside of its stated boundaries. These seem sufficient to me, and it is difficult to explain to students why no one has taken account of them.

A. The Code Says So

First, the Texas Business Organizations Code itself says that the statute's reach is limited. The reorganization of business entity statutes that became the Texas Business Organizations Code was conducted on a well-known principle: Those statutes that apply to all "domestic entities" (defined to include any entity "formed under" the code or "the internal affairs of which are governed by" the code[134]) and foreign entities (formed under or governed in their internal affairs by the laws of other states[135]) are included under the General Provisions, comprising Title 1.[136] Those provisions governing only specific kinds of domestic entities are set forth in other titles, one title each for each kind of entity. So Title 2 governs corporations. Title 3 governs LLCs. Lest there be any confusion, the TBOC specifically authorizes the citation of Title 2 and those provisions of Title 1 applicable to corporations as "the 'Texas Corporation Law.'"[137] The provisions of Title 3 and the provisions of Title 1 applicable to LLCs may be cited as "the 'Texas Limited Liability Company Law.'"[138]

The code really does assert that its organization means something. Thus, it provides, "Each title of this code, other than this title [Title 1], applies to a different type of entity to the extent provided by that title." Thus, when Title 2's Chapter 21, which contains the limitation on veil piercing, provides, "This chapter applies only to a: (1) domestic for-profit corporation formed under this code, and (2) foreign for-profit corporation that is transacting business in this state," we should take that at face value. Title 2 thus applies only to for-profit corporations.

What does this provision of the statute mean if courts can, as Professor Miller says, develop the common law by applying statutes wherever they see no reason not to? To say, as Professor Miller does, that in applying the corporate veil-piercing limitation to LLCs the courts are only developing the common law reads these limiting provisions right out of the code. When the courts want to apply the Texas Limited Liability Company Law to a Texas LLC, they are applying the statute; when they want to apply the Texas Corporation Law to a Texas LLC, they are simply developing the common law? It's all too convenient, and it ignores the plain language of the code.

In fact, it also ignores changes to Texas limited liability company law that have occurred over time. A provision of the Texas Limited Liability Company Act as passed in 1991

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[133] Miller, *supra* note 120, at 418.

[134] TEX. BUS. ORGS. CODE ANN. § 1.002(17) & (18) (Vernon 2010).

[135] *See id.* § 1.002(27).

[136] *See id.* § 1.106(a).

[137] *See id.* § 1.008(b).

[138] *See id.* § 1.008(e).

provided,

> To the extent this Act contains no provision with respect to one of the matters provided for in the TBCA or the Texas Miscellaneous Corporation Laws Act as such acts shall be amended from time to time, the provisions of the TBCA and the Texas Miscellaneous Corporation Laws Act shall supplement the provisions of this Act to the extent they are not inconsistent with the provisions of this Act.[139]

This statute might well have mandated that the Texas Business Corporation Act's veil-piercing statute[140] be applied to LLCs. However, two years later, this provision of the Texas LLC Act was amended to name specifically only certain provisions of the TBCA that would apply to LLCs.[141] The corporate veil-piercing statute, which was amended in *the same bill*,[142] was omitted from the list.[143] This legislative move is a clear rejection of the general application of corporate statutes to LLCs, and a specific rejection of the application of the corporate veil-piercing statute to LLCs. Later, when the TBOC was passed, the legislature again omitted the veil-piercing statute from the Texas Limited Liability Company Law.[144]

Not only is the export of corporate provisions to other entities forbidden by the code, it not a good idea, generally. Each entity is designed specifically by the legislature with attributes that enhance its function and value. For example, it is not uncommon to set up an LLC with something like a corporate structure. The managers or members who are to manage might in the company agreement be called a board. Under the LLC statutes, if the LLC has managers, those managers—the board—are the LLC's governing authority.[145] The code directs that the governing authority "shall manage the business and affairs of the company."[146] A majority of this board constitute a quorum.[147] The affirmative vote a majority of the board pre-

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[139] Texas Limited Liability Company Act Art. 1528n, Art. 8.12; Acts 1991, 72nd Leg., ch. 901, § 46, eff. Aug. 26, 1991.

[140] The provision was then codified at Texas Business Corporation Act Art. 2.21 (1990); Acts 1989, 71st Leg., ch. 801, § 7, eff. Aug. 28, 1989.

[141] *See* Texas Business Corporation Act Art. 8.12 (1992); Acts 1993, 73rd Leg., ch. 215, § 1.25, eff. Sept. 1, 1993.

[142] *See* Acts 1993, 73rd Leg., ch. 215, § 2.05, eff. Sept. 1, 1993.

[143] *See id.* The Bill Analysis for Acts 1993, 73rd Leg., ch. 215, § 1.25, states that the amendment "[p]rovides specificity as to the incorporation of certain provisions of the TBCA and Texas Miscellaneous Corporation Laws Act." Bill Analysis, HB 1239, *codified at* Acts 1993, 73rd Leg., ch. 215, *available at* http://www.lrl.state.tx.us/legis/billsearch/text.cfm?legSession=73-0&billtypeDetail=HB&billNumberDetail=1239&billSuffix=&startRow=1&IDlist=&unClicklist=&number=100. This change was noted at Hamilton, Mill, & Ragazzo, *supra* note 112, at § 20.7 n.4.

[144] The TBOC drafters omitted from the Texas Limited Liability Company Law a provision similar to TLLCA § 8.04, which incorporated explicitly named provisions of the TBCA. Instead, the TBOC made those provisions of the TBCA applicable to LLCs by placing the substantive elements of those TBCA provisions in Title 1 of the TBCA. *See, e.g.*, Texas Corporation and Partnership Laws XXXIX (West 2010) (a disposition table showing where the substantive provisions former located in 8.04 can now be located: all but those pertaining to derivative actions can be found in Title 1).

[145] TEX. BUS. ORGS. CODE ANN. § 101.251 (Vernon 2010).

[146] *See id.* § 101.252.

[147] *See id.* § 101.353.

sent at a meeting at which a quorum is present constitutes an act of the governing authority.[148] These provisions all have corporate analogs. The board is the corporation's governing authority.[149] A majority of the board constitutes a quorum.[150] The affirmative vote of a majority of the board present at a meeting at which a quorum is present constitutes an act of the board.[151]

To some extent, both LLC provisions and corporate provisions are variable by contract.[152] The corporate code provisions allowing different percentages of attending board members to form a quorum is limited, however; it may be no less than one-third of the number of board members.[153] Likewise, the minimum number of directors of a quorum who must vote for something may also be varied, but only by increasing it.[154] The number cannot be lowered. Surely these are wise limitations. Requiring that at least a third of board members meet in order to do business ensures that some deliberation takes place. Requiring at least a majority of a quorum to sign onto decisions makes it more probable that decisions are rational. But the LLC code contains no such limitations. No statute I have found limits the percentage of governing persons that can make up a quorum.[155] It could be a single manager. Aside from some particular instances named by the code, the number of votes necessary for an action to take place appears to be equally malleable. It apparently could be less than a majority: perhaps a plurality, or perhaps a single manager.[156]

Should the common law of LLCs be developed by adopting in the limitations of the corporate code, in order to protect the non-managing members? Why not? It seems to me the best reason why not is that, if the code wanted LLCs to be governed like corporations, it would have said so. Instead, it appears to say differently. Surely this reason is applicable to the veil piercing "common law," too. Business entities are fictions, or, alternately, are perhaps better thought of as a shorthand reference to a number of legal conclusions that are always or usually true of an entity of a certain type. Legislatures define business entities deliberately, or at least that is what a court is supposed to assume. The Texas legislature has defined corporations and LLCs the way it wants them, and it has directed that the veil piercing statute should apply to corporations, not to LLCs. Allowing common law development of entity law would turn the design of entities over to the courts, who can change the attributes of entities at best in piecemeal fashion over many years, and never with complete coherence over the short term. Business needs more certainty than that.

Last September, the First District Court of Appeals in Houston decided a case involv-

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[148] *See id.* § 101.355.

[149] *See id.* § 21.401.

[150] *See id.* § 21.413(a).

[151] *See id.* § 21.415(a).

[152] *See id.* §§ 21.101, 21.106, 21.109, 21.413(a) (allowing different quorum requirements in the bylaws or certificate of formation); 21.415(a) (allowing different voting percentages in the bylaws of the certificate of formation); TBOC 101.054.

[153] *See id.* § 21.413(b).

[154] *See id.* § 21.415(a).

[155] *See id.* §§ 101.054, 101.353.

[156] *See id.* §§ 101.054, 101.355.

ing whether to pierce the veil of an LLC.[157] In the trial court, no one, it appears, knew that they were to apply corporate law to LLCs. Neither party argued that section 21.223 of the Texas Corporation Law or its predecessor should apply.[158] The trial court issued the jury charge without mentioning it.[159] Perhaps the lawyers and the court should have noticed the case law in this area,[160] but there is no evidence that they they did not look in the right place in the code, is there? Please, let us have some guidance, here.

B. Clarity

A second reason not to apply the statute to LLCs is that its meaning is uncertain. Applying this poorly drafted statute to a new set of entities would only magnify the interpretive problems created by the statute.

The language of the 1989 statute, at first and as amended in 1993, is unclear for two reasons. First, in order that a shareholder be held liable for a contractual obligation of the corporation, the court must find "actual fraud" by the shareholder.

The statute specifies this in a convoluted manner. It first provides that no shareholder will be liable for any contractual obligation of the corporation on the basis that the shareholder "is or was the alter ego of the corporation or on the basis of actual or constructive fraud, a sham to perpetrate a fraud, or other similar theory."[161] Whence this long list? It is evidence of the legislature's antipathy to the loose language of the 1986 Supreme Court decision, *Castleberry*.[162] *Castleberry* went out of its way to state its own long list of general categories of conduct that would justify veil-piercing. The breadth of the categories appeared to leave courts a great deal of discretion: fraud, sham to perpetrate a fraud, alter ego, means of evading an existing legal obligation, mere tool or business conduit of another corporation, inadequate capitalization—in short, whenever "the corporate form has been used as part of a basically unfair device to achieve an inequitable result."[163] Lest "sham to perpetrate a fraud" be confused with mere fraud, the *Castleberry* court distinguished the two:

> To prove there has been a sham to perpetrate a fraud, tort claimants and contract creditors must show only constructive fraud. We distinguished constructive from actual fraud in *Archer v. Griffith*:
>
> > Actual fraud usually involves dishonesty of purpose or intent to deceive, whereas constructive fraud is the breach of some legal or equitable duty which, irrespective of moral guilt, the law declares fraudulent because of its tendency to deceive

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[157] Phillips v. B.R. Brick & Masonry, Inc., 01-09-00311-CV, 2010 WL 3564820 (Tex. App.—Houston [1st Dist.], September 10, 2010).

[158] *Id.* at *7 n.6.

[159] *Id.*

[160] McCarthy, 251 S.W.3d at 589 (applying § 21.223 to the issue of whether a LLC's veil could be pierced).

[161] TEX. BUS. ORGS. CODE ANN. § 2.21(a)(2) (Vernon 2010).

[162] Castleberry, 721 S.W.2d 270.

[163] *Id.* at 271-72.

> others, to violate confidence, or to injure public interests.[164]

The statute's purpose in naming the theories appears to be to oppose *Castleberry*'s long list. Note that *Castleberry* included actual fraud in its long list, and so does the statute include actual fraud in the list of prohibited theories.

But, after taking away liability based on actual fraud with one hand, the code provides it with the other: That provision "does not ... limit the liability of a [share]holder ... if ... the [share]holder ... caused the corporation to be used for the purpose of perpetrating and did perpetrate an actual fraud on the obligee primarily for the direct personal benefit of the [share]holder."[165] That take-and-give-back drafting method combined with the natural ambiguity of the phrase "actual fraud" leave us wondering what "actual fraud" is supposed to mean. The phrase was used in *Castleberry* itself, in the passage quoted above. It might mean nothing more than conduct "involv[ing] dishonesty of purpose or intent to deceive."

Or, on the other hand, it might mean something else, like the tort of fraud. One might quite logically assume that, the legislature having said "actual fraud," the tort of actual fraud was what was wanted. That is the way my students sometimes read it.

> The elements of fraud are: (1) that a material representation was made; (2) the representation was false; (3) when the representation was made, the speaker knew it was false or made it recklessly without any knowledge of the truth and as a positive assertion; (4) the speaker made the representation with the intent that the other party should act upon it; (5) the party acted in reliance on the representation; and (6) the party thereby suffered injury.[166]

The statute appears to demand that this be the new test for imposing corporate liability on a shareholder. The irony of that construction of the statute would be that if these elements are proved, the shareholder committed a tort and is liable in tort. No veil piercing is necessary to hold a defrauder liable for fraud, as the courts have recognized.[167] And the damage rule for the tort of fraud is in fact broad enough itself to cover the corporate liability. Damages from fraud include either money paid out of pocket in reliance on the fraud, or the benefit of the promised, fraudulent bargain.[168] "When properly pleaded and proved, consequential damages that are foreseeable and directly traceable to the fraud and result from it might be recoverable."[169] If the fraud consisted in tricking the obligee into accepting an obligation of the corporation (as most often would be true for a case involving contractual liability of a corporation), then that obligation would be the benefit of the bargain, and money paid out by the plaintiff for it would be out of pocket. These would be the contract damages due from the corporation, and these

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[164] Castleberry, 721 S.W.2d at 273 (quoting Archer v. Griffith, 390 S.W.2d 735, 740 (Tex. 1964)).

[165] TEX. BUS. ORGS. CODE ANN. § 2.21(b) (Vernon 2010).

[166] Aquaplex, Inc. v. Rancho La Valencia, Inc., 297 S.W.3d 768, 774 (Tex. 2009).

[167] Sanchez, 274 S.W.3d at 712.

[168] Baylor Univ. v. Sonnichsen, 221 S.W.3d 632, 636 (Tex.2007); Formosa Plastics Corp. USA v. Presidio Eng'rs & Contractors, Inc., 960 S.W.2d 41, 49 (Tex.1998); Arthur Andersen & Co. v. Perry Equip. Corp., 945 S.W.2d 812, 817 (Tex.1997).

[169] Formosa Plastics Corp. USA, 960 S.W.2d at 49.

would also be the damages due the plaintiff under the common law tort of fraud in an action against the defrauding shareholder. But, of course, we did not need a statute for that. We had the common law tort of fraud already. It appears that the statute reserves liability that defendants already had under the common law, making a reservation of liability for actual fraud pointless.

There is another possibility. It is possible that the statute means to require that the tort of fraud be proved in order to make the shareholder liable for some corporate liability *even if unrelated to the fraud.* Perhaps the tort resulted in no or little damages, or some measure of damages not coinciding with the damages owed by the corporation in contract. The statute does not require that the "actual fraud" result in the corporate liability. In fact, it does not require any relation between the fraud and the contractual obligation at all: "Subsection (a)(2) does not prevent or limit the liability of a [share]holder ... if ... the holder ... did perpetrate an actual fraud," but not necessarily a fraud related to the corporate contractual liability. The statute does not require that the shareholder be liable "to the extent" of the fraud, for instance. This would be a remarkable statute if it actually means fraud whether or not related to the corporate liability, but it would not be without precedent.[170] However, the use of the phrase "actual fraud" in both (a)(2) and (b) suggests that the corporate debt should be related in some way to the fraud, as if that debt is the actual fraud for which the shareholder would be liable. Moreover, the suggestion that committing the tort of fraud should subject a person under this section of the Texas Corporation Laws to greater or different damages than could be had under the common law for the tort of fraud would be an enlargement of tort law that one should expect to be announced more clearly than this, if, that is, the statute by naming "actual fraud" means to refer to the tort of fraud.

Yet, the statute's language does not clearly call for this interpretation. The statute describes "actual fraud" without any limitations, and without clearly referring to the tort. Moreover, it uses the term "actual fraud" rather than "the tort of fraud" or merely "fraud." The phrase "actual fraud" comes (apparently) from *Castleberry* itself (it being the closest relevant authority), and it is doubtful, given *Castleberry*'s broad dicta, whether it meant the tort. It defined "actual fraud" as including a mental state: "usually involves dishonesty of purpose or intent to deceive."[171] Beyond that, the case distinguished a sham to perpetrate a fraud from "common-law fraud or deceit," as if the tort were required.[172] But the court also distinguished a sham to perpetrate a fraud, or constructive fraud, from "intentional fraud" by saying that "[n]either fraud nor an intent to defraud" was required, and this language suggests that an intent to defraud could have been the "something more than constructive fraud" that the court was considering. That the statute's phrase "actual fraud" appears to be lifted from this confusing *Castleberry* dicta leaves the phrase open to interpretation as a mental state, or the tort of fraud, or perhaps something else.

Perhaps because of this ambiguity and because the statute's reservation clause, read to refer to the tort, might well be superfluous, courts have generally not taken it literally. Sorting this out has taken some time. The statute was passed in 1989 and the courts of appeals are on-

[170] For a similar move under Rule 10b-5 of the federal securities law, *see* U.S. v. O'Hagan, 521 U.S. 642 (1997).

[171] Castleberry, 721 S.W.2d at 273 (quoting Archer, 390 S.W.2d at 740).

[172] Castleberry, 721 S.W.2d at 273.

ly now clarifying what "actual fraud" means.[173] Rather than require that the tort of fraud be proved, courts, especially lately, have required merely that the shareholder have had some dishonesty of purpose or intent to deceive, which of course is something less than the tort of actual fraud.[174] This comes with controversy, as commentators now assert that the tort was what was intended.[175] The commentators do not address the ambiguity in the phrase "actual fraud," however, or what the point of the statute was if the tort is required, since shareholders who commit fraud were already liable without the statute in tort to corporate obligees.

As if the phrase "actual fraud" were not uncertainty enough, an equally ambiguous clause is the statute's list of theories. The statute prohibits veil piercing for contractual liabilities "on the basis that the [share]holder ... is or was the alter ego of the corporation or on the basis of actual or constructive fraud, a sham to perpetrate a fraud, or *other similar theory*."[176] Commentators have been clocking the evolution of the "other similar theory" clause over the years.[177] Only repeated visits to the courts of appeals have begun to settle its meaning. The "ratification" theory was included as an "other similar theory" only in 2006.[178] The single business enterprise theory was classed as one in 2003.[179] Will other theories arise to test the clause? Surely, and surely given the differences in form between a corporation and a LLC, litigants will seek a hearing on each theory for each entity, especially if development of LLC veil-piercing law is considered to be only common law development, as Professor Miller suggests.[180]

But why should the law multiply this ambiguity by applying the statute to an additional entity? In light of such ambiguity, LLCs would be better served if the legislature were

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[173] *See* Latham v. Burgher, 320 S.W.3d 602 (Tex. App.—Dallas 2010, no pet.) (discussing the issue at length and resolving it); Dick's Last Resort of W. End, Inc. v. Mkt./Ross, Ltd., 273 S.W.3d 905, 908-09 (Tex. App.—Dallas 2008, pet. denied) (discussing the issue at length and resolving it); Solutioneers Consulting, Ltd. v. Gulf Greyhound Partners, Ltd., 237 S.W.3d 379, 387-89 (Tex. App.—Houston [14th Dist.] 2007, no pet.) (referring to a brief passage in *Castleberry v. Branscum* that "usually involves dishonesty of purpose or intent to deceive" in order to define the meaning of the statute meant to supersede the language of *Castleberry*).

[174] Latham, 320 S.W.3d 602 ("[I]n the context of piercing the corporate veil, actual fraud is not equivalent to the tort of fraud. Instead, in that context, actual fraud involves 'dishonesty of purpose or intent to deceive.'"); *see* Dick's Last Resort of W. End, Inc., 273 S.W.3d at 908-09; Solutioneers Consulting, Ltd., 237 S.W.3d at 387-89.

[175] *See* Glenn D. West & Stacie L. Cargill, *Corporations*, 62 SMU L. Rev. 1057, 1066-1073 (2009).

[176] TEX. BUS. ORGS. CODE ANN. § 21.223(a)(2) (Vernon 2010) (italics added). The phrase in italics was added to the statute in 1993.

[177] *See, e.g.*, Hamilton, Miller & Ragazzo, *supra* note 112, at §§ 26.22-26.23; Miller, *supra* note 120, at 406-14; West & Cargill, *supra* note 175, at 1059-74; Glenn D. West & W. Benton Lewis, Jr., *Corporations*, 61 SMU L. Rev. 743, 746-54 (2008); Glenn D. West & Emmanuel U. Obi, *Corporations*, 60 SMU L. Rev. 885, 886-95 (2007); Glenn D. West & Benton B. Bodamer, *Corporations*, 59 SMU L. Rev. 1143, 1145-53 (2006); Marc I. Steinberg, *Alter Ego and Single Business Enterprise in the Texas Contractual Debt Context,* 41 Tex. J. Bus. L. 1 (2005); Glenn D. West & Susan Y. Chao, *Corporations*, 56 S.M.U. L. Rev. 1395, 1403-08 (2003); Glenn D. West & Brandy L. Treadway, *Corporations*, 55 SMU L. Rev. 803, 810-11, 815 (2002); Alan W. Tompkins & Theodore S. O'Neal, *Corporations*, 52 SMU L. Rev. 873, 874-80 (1999). Mr. West's felt need at least since 2005 constantly to interpret this statute for the courts, and criticize at length every court decision on this issue with which he disagrees, is itself evidence of the statute's lack of clarity.

[178] Willis v. Donnelly, 199 S.W.3d 262, 273 (Tex. 2006).

[179] S. Union Co. v. City of Edinburg, 129 S.W.3d 74, 85-90 (Tex. 2003).

[180] *See supra* notes 132 & 133 and accompanying text.

to take another try at drafting something clearer. Or perhaps the Texas Supreme Court, which seems itself to favor common law more friendly to businesses on this issue,[181] should develop the law in this area. I for one believe they would do a better job than the drafters of this statute.

C. The Party Ends with the Corporation

Finally, another statute that is part of the Texas Limited Liability Company Law weighs in on the propriety of collecting a LLC debt from a member: "A member of a limited liability company may be named as a party in an action by or against the limited liability company only if the action is brought to enforce the member's right against or liability to the company."[182] This provision, which appears only in the Texas Limited Liability Company Law and not in the Texas Corporation Law, has not been construed by the state's courts.[183] The provision's plain language throws a wrench in a veil-piercing claim involving a LLC, however.

Veil-piercing is itself not an independent claim. "An attempt to pierce the corporate veil, in and of itself, is not a cause of action but rather is a means of imposing liability on an underlying cause of action such as a tort or breach of contract."[184] Veil-piercing "is merely a ground upon which the individual may be held liable upon a cause of action which otherwise would have existed only against the corporation."[185] Commonly, shareholders are named party defendants in actions seeking veil-piercing as a remedy for corporate liability.[186] Once the corporation is held liable, and veil-piercing prerequisites met, shareholders are adjudged liable for the corporate liability.

This would not be possible in a suit against an LLC. A suit seeking veil-piercing must allege some cause of action against the LLC other than veil-piercing, such as tort (through the agency doctrine of *respondeat superior*) or contract. If the suit is successful on such a cause of action against the LLC, then under veil-piercing law a member might be held liable. But in order for the member to be held liable, the member must be a party to the suit, the very thing prohibited by the statute. The exceptions to the statute, for member derivative

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[181] SSP Partners, 275 S.W.3d at 450-56.

[182] TEX. BUS. ORGS. CODE ANN. § 101.113 (Vernon 2010).

[183] *Harris v. Guetersloh*, 07-99-0046-CV, 2000 WL 12523 (Tex.App.—Amarillo, Jan. 6, 2000, no pet.), suggested that, under the statute's predecessor, the defense provided by the statute must be raised by a defendant affirmatively or was waived. Other than this case, I have found no mention of the provision.

[184] Gallagher v. McClure Bintliff, 740 S.W.2d 118, 119-20 (Tex. App.—Austin 1987, writ denied); *see, e.g.,* Phillips v. United Heritage Corp., 319 S.W.3d 156, 158 (Tex. App.—Waco 2010, no pet.) ("[T]hese theories and the attempts to utilize them are not substantive causes of action."); Wilson v. Davis, 305 S.W.3d 57, 68 (Tex. App.—Houston [1st Dist.] 2009, no pet.); Cox v. S. Garrett, L.L.C., 245 S.W.3d 574, 582 (Tex. App.—Houston [1st Dist.] 2007, no pet.); Specialty Retailers, Inc. v. Fuqua, 29 S.W.3d 140, 147 (Tex. App.—Houston [14th Dist.] 2000, pet. denied); Farr v. Sun World Sav. Ass'n, 810 S.W.2d 294, 297 (Tex. App.—El Paso 1991, no writ); Gulf Reduction Corp. v. Boyles Galvanizing & Plating Co., 456 S.W.2d 476, 479 (Tex. App. 1970).

[185] Gulf Reduction Corp. v. Boyles Galvanizing & Plating Co., 456 S.W.2d 476, 479 (Tex. App.—Fort Worth 1970, no writ).

[186] *See, e.g.*, Seidler v. Morgan, 277 S.W.3d 549, 557 (Tex. App.—Texarkana 2009, pet. denied) ("Seidler also argues that there is some evidence to suggest that it would be appropriate to pierce the corporate veil, and thereby show that Morgan[, a shareholder,] was a proper party.").

suits[187] and suits brought by the company against the member, obviously do not apply.

Could a second, separate suit be brought against the member? That would seem an odd result. Most likely the member would not be bound by the earlier suit, to which it was not a party.[188] The underlying LLC liability would have to be litigated a second time. Moreover, one would have to ask whether, in the second suit against the member for veil-piercing liability, the complaint would withstand a motion to dismiss for failure to state a claim. Veil-piercing is not a cause of action, and the claim in the veil-piercing suit would be a claim only against the LLC, not a member. For this last reason, third party claimants would also not be able to bring a claim against a LLC member without first suing the entity.

The no-member-party rule is not hindered by Rule 39(a)(1) of the Texas Rules of Civil Procedure. That rule provides, "A person who is subject to service of process shall be joined as a party in the action if ... in his absence complete relief cannot be accorded among those already parties."[189] First of all, if a rule of civil procedure conflicts with a statute, the statute controls unless the rule is passed last.[190] Rule 39 was last amended in 1971, however.[191] The no-member-party rule first came into being in 1991[192] and was placed in its present form by legislative act in 2003.[193] Second, the no-member-party rule is also far more specific than Rule 39, and therefore should control if a conflict exists.[194] Finally, no conflict exists. Rule 39(a)(1) is satisfied even without the LLC member's participation in a suit because the LLC is a party; a judgment for the full amount of damages can be rendered against the LLC. Rule 39's

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[187] *See* TEX. BUS. ORGS. CODE ANN. § 101.451 et seq. (Vernon 2010).

[188] Generally, a person is not bound by a judgment in a suit to which she was not a party. Amstadt v. U.S. Brass Corp., 919 S.W.2d 644, 652 (Tex. 1996). An exception exists for those "in privity with the parties to the original suit." *Id.* at 652-53. "People can be in privity in at least three ways: (1) they can control an action even if they are not parties to it; (2) their interests can be represented by a party to the action; or (3) they can be successors in interest, deriving their claims through a party to the prior action." *Id.* at 653. However, "a party's mere status as shareholder does not create privity [with the corporation] absent further evidence." Tex. Capital Sec. Mgmt., Inc. v. Sandefer, 80 S.W.3d 260, 265-67 (Tex. App.—Texarkana 2002, pet. struck); *see also* Dudley v. Smith, 504 F.2d 979, 982 (5th Cir.1974); Am. Range Lines, Inc. v. C.I.R., 200 F.2d 844, 845 (2d Cir.1952). In *Sandefer*, the court held that not even the shareholders' additional status as officers of the corporation conferred privity. *Sandefer*, 80 S.W.3d at 266 ("This status alone, without more evidence, does not, as a matter of law, establish privity."); *accord* T.L. Dallas (Special Risks), Ltd. v. Elton Porter Marine Ins. Agency, CIVA 3:07-CV-0419, 2008 WL 7627806, *6, (S.D.Tex. Dec. 22, 2008); Brown v. Zimmerman, 160 S.W.3d 695, 703 (Tex. App.—Dallas 2005, no pet.). Moreover, "mere participation in a prior trial does not suffice to bar the participant on principles of res judicata, nor does knowledge of an ongoing trial." Brown, 160 S.W.2d at 703. The upshot is that well-counseled shareholders or LLC members will not participate in the corporate or LLC litigation, nor control it, and hence will be less likely to be bound.

[189] Tex. R. Civ. Pro. 39(a)(1).

[190] V.T.C.A., Government Code § 22.004(c); Johnstone v. State, 22 S.W.3d 408, 409 (Tex. 2000); Villasan v. O'Rourke, 166 S.W.3d 752, 762 (Tex. App.—Beaumont 2005, pet. denied).

[191] V.T.R.Ann. Rule 39 Credits.

[192] Acts 1991, 72nd Leg., ch. 901, § 46, eff. Aug. 26, 1991.

[193] Acts 2003, 78th Leg., ch. 182, § 1, eff. Jan. 1, 2006.

[194] TEX. BUS. ORGS. CODE ANN. § 1.051 (Vernon 2010) (mandating that Chapter 311 of the Government Code apply to construction of each provision of the TBOC); V.T.C.A., Government Code § 311.026(b) ("If the conflict between the general provision and the special or local provision is irreconcilable, the special or local provision prevails as an exception to the general provision, unless the general provision is the later enactment and the manifest intent is that the general provision prevail.")

purpose is to allow complete adjudication of disputes, not ensure the existence of a defendant with the means to pay a judgment.[195]

Whatever section 101.113's purposes and effects are, it is not friendly to veil-piercing suits. The application of the corporate veil-piercing statute to LLCs assumes that the law of veil piercing applies to LLCs just as it does to corporations. But the no-member-party statute prohibits the normal corporate veil-piercing suit against an LLC member and raises questions as to whether such a suit could proceed at all. The result is that the analogy is dissimilar, and the "why not?" attitude of courts and commentators unjustified.

Incidentally, every Texas case in which LLC veil-piercing succeeded or was approved as a theory appears to have violated this statute.[196] The lawyers appear to have had no idea of the violation. Clearly it is time to begin paying attention to the language of the code. Pretending that an LLC is just like a corporation is not the way to encourage the bar to follow the TBOC.

Because the code expressly indicates that the corporate veil-piercing statute, TBOC section 21.223, should apply only to corporations; because the provision is awkwardly drafted and not one wisely adopted elsewhere by the common law; and because LLC members cannot be party defendants in actions against LLCs, anyway, I conclude that TBOC section 21.223 would best not be applied to LLCs. The legislature should, if it wishes such a thing to occur, write a statute for LLCs and place it in the Texas Limited Liability Company Law. That would resolve the first objection named here, and it would clarify that the legislature really did want such a poorly drafted statute to apply to LLCs as well as corporations. Better yet, the legislature should re-draft the statute and place a much clearer one in the Texas Limited Liability Company Law. I will leave its contents to them and hope they avoid the clear inadequacies of the corporate rule.

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[195] Hall v. Dorsey, 596 S.W.2d 565, 570 (Tex. Civ. App.—Houston [1st Dist.] 1980) ("Rule 39(a) is designed to avoid subjecting a person to the risk of paying the same claim more than once. ")

[196] Members are, inexplicably, with no reference to the no-member-party statute, party defendants with LLCs of which they are members in *Watkins*, 2011 WL 1414135, at *1; *Genssler*, 2010 WL 3928550, at *1-3; *Phillips*, 2010 WL 3564820; *Sanchez*, 274 S.W.3d at 712; *McCarthy*, 251 S.W.3d at 589; and in all the federal cases: In re *Houston Drywall, Inc*., 05-95161-H4-7, 2008 WL 2754526, *32 (Bankr. S.D. Tex. July 10, 2008); *Bramante*, 2007 WL 4555943; DDH Aviation, L.L.C. v. Holly, 2005 WL 770595, **5-8 (N.D. Tex. Mar. 31, 2005); In re *Moore*, 379 B.R. 284, 284 et seq. & 289 n.4 (Bankr. N.D. Tex. 2007); and In re JNS *Aviation, LLC*, 376 B.R. 500, 525-31 (Bankr. N.D. Tex. 2007).

NEW SCHEDULE UTP: "UNCERTAIN TAX POSITIONS IN THE AGE OF TRANSPARENCY"

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I. INTRODUCTION

A taxpayer, when signing the jurat on the tax return, swears under penalties of perjury that the tax return is true, accurate, and complete.[1] But, as a general rule, the taxpayer need not have a subjective belief that the tax position taken on the tax return is sustainable when making this sworn statement.[2] Furthermore, tax advisors need not believe that a tax position is ultimately sustainable before they advise the client to take a position on a tax return.[3]

This leniency in the nation's tax reporting standard contributes to the nation's "tax gap."[4] For 2001, the IRS estimates that the tax gap was $345 billion.[5] The IRS estimates that 83.7% of the taxes that were required to be paid in 2001 were voluntarily paid, and this $345 billion compliance gap represents 16.3% of the amount of the total taxes that should have been

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[1] *See, e.g.*, IRS, DEP'T OF THE TREASURY, FORM 1040 (2011), *available at* http://www.irs.gov /pub/irs-pdf/f1040.pdf; IRS, DEP'T OF THE TREASURY, FORM 1120 (2011), *available at* http://www.irs.gov/pub/irs-pdf/f1120.pdf.

[2] *See* 26 U.S.C. § 6662(d)(2)(B)(i) (2006). The general rule is that if the tax position being considered is not a tax shelter item nor is it a listed transaction, then a taxpayer can claim the tax position without disclosure as long as the position has at least "substantial authority." *See id.* The Joint Committee on Taxation has stated that "substantial authority" exists for a tax position if its chances of success are at least 40%. *See, e.g.*, JOINT COMM. ON TAXATION, JCX-79-99, COMPARISON OF RECOMMENDATIONS OF THE JOINT COMMITTEE ON TAXATION STAFF AND THE TREASURY RELATING TO INTEREST AND PENALTIES 13 (1999), *available at* www.jct.gov/ publications.html?func=startdown&id=2836. Current law allows taxpayers to take even more aggressive tax positions that do not possess "substantial authority" without risk of an accuracy- related penalty if the tax position has a "reasonable basis" and is disclosed on the tax return. *See* 26 U.S.C. § 6662(d)(2)(B)(ii)(I). A corporation is never treated as having a reasonable basis for its tax treatment if the underlying transaction represents a "multiple-party financing transaction." *See id.* § 6662(d)(2)(B). In all other situations, the Joint Committee on Taxation has stated that a "reasonable basis" for a tax position exists if there is at least a 20% chance of it being sustained. *See, e.g.*, JOINT COMM. ON TAXATION, *supra*, at 13. Two limited exceptions exist to the above general rule. First, if the tax position being considered were a tax shelter item, the taxpayer must demonstrate that the taxpayer reasonably believed that the tax position was more likely than not correct. *See* Treas. Reg. § 1.6664-4(f)(2)(i)(A)–(B) (as amended in 2003). Second, if the tax position in question were a "reportable transaction," the taxpayer has reasonable cause to claim the tax benefits only if the taxpayer reasonably believed at the time the return was filed that the tax treatment is likely correct and the position is adequately disclosed on the tax return. *See* 26 U.S.C. § 6662A(d)(2).

[3] The Treasury Department has been authorized to regulate tax practice and has exercised that authority by issuing proposed regulations providing that a tax advisor generally can advocate an uncertain tax position as long as claiming the uncertain tax position complies with the tax reporting standards for taking the position without penalty. *See* 31 C.F.R. §330 (2011); Regulations Governing Practice Before the Internal Revenue Service, 75 Fed. Reg. 51,713, 51,714 (Aug. 23, 2010) (to be codified at 31 C.F.R. pt. 10).

[4] The "tax gap" refers to the difference between what taxpayers owe on their return and the amount that they voluntarily pay in a timely manner. *See* Nina E. Olson, *Closing the Tax Gap: Minding the Gap: A Ten-Step Program For Better Tax Compliance*, 20 STAN. L. & POL'Y REV. 7, 7–8 (2009). The IRS made tax gap studies for tax years 1979, 1983, 1987, and 2001. For a discussion of the slightly different definitions used to define the tax gap over the years, *see* U.S. Gen. Accounting Office, Tax Administration: IRS' Tax Gap Studies (1988).

[5] IRS, DEP'T OF THE TREASURY, TAX YEAR 2001 FEDERAL TAX GAP 1 (2001), *available at* http://www.irs.gov/pub/irs-news/tax_gap_figures.pdf; *see also* I.R.S. News Release IR-2006-28 (Feb. 14, 2006), 2006 WL 330160, *available at* http://www.irs.gov/newsroom/article/0,,id =154496,00.html; OFFICE OF TAX POLICY, DEP'T OF THE TREASURY, A COMPREHENSIVE STRATEGY FOR REDUCING THE TAX GAP 5 (2006), *available at* http://www.treasury.gov/press- center/press-releases/Documents/otptaxgapstrategy%20final.pdf.

paid for that year.[6] Congress has reacted strongly to the tax gap, stating that the unwillingness of some to pay their taxes in a timely manner creates an unfair burden on honest taxpayers.[7] Furthermore, Congress has called for more aggressive efforts to reduce the tax gap.[8] To achieve this objective, Congress, the U.S. Treasury Department, and tax commentators have offered numerous solutions.[9] Yet, the reality is that the tax gap has remained largely unchanged since 1973.[10] Most citizens prefer not to pay higher taxes,[11] but even more so, they prefer not paying additional taxes when they are meeting their tax obligations and believe that others are not paying what they already owe.[12] Furthermore, a vast majority of Americans be-

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[6] *See* IRS, DEP'T OF THE TREASURY, TAX YEAR 2001 FEDERAL TAX GAP 1 (2001), *available at* http://www.irs.gov/pub/irs-news/tax_gap_figures.pdf; *see also* I.R.S. News Release IR-2006-28 (Feb. 14, 2006), 2006 WL 330160, *available at* http://www.irs.gov/newsroom/article/0,,id =154496,00.html; OFFICE OF TAX POLICY, DEP'T OF THE TREASURY, A COMPREHENSIVE STRATEGY FOR REDUCING THE TAX GAP 5 (2006), *available at* http://www.treasury.gov/presscenter/ press-releases/Documents/otptaxgapstrategy%20final.pdf.

[7] Carol Guthrie, *Sen. Baucaus Calls New Tax Gap Numbers "Unacceptable," Calls For Bolder IRS Action to Collect Taxes Owed*, U.S. FED. NEWS, Feb. 14, 2006; *see also GSA Contractors Who Cheat on Their Taxes and What Should Be Done About It: Hearing Before the Permanent Subcomm. on Investigation*, 109th Cong. 2 (2006) (statement of Sen. Carl Levin) ("[W]hen so many Americans fail to pay the taxes that they owe, it begins to undermine the fairness of our tax system, forcing honest taxpayers to make up the shortfall needed to pay for basic Federal protections . . . .").

[8] *See, e.g.*, Memorandum from Sen. Charles Grassley on Tax Gap Numbers (Feb. 14, 2006); Stephen Joyce, *Everson Urges Fiscal 2008 Request Approval; Conrad Calls Tax Gap Proposals 'Too Modest'*, 31 DAILY TAX REP. (BNA), at G-2 (Feb. 15, 2007) (Sen. Kent Conrad, D-ND, sought a "far more aggressive approach" to close the tax gap).

[9] *See* DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2008 REVENUE PROPOSALS, at 61-82 (2007); *see also* I.R.S., Reducing the Federal Tax Gap: A Report on Improving Voluntary Compliance, at 3 (2007); Olson, *supra* note 4, at 8, 35.

[10] ABA Comm. on Taxpayer Compliance, *Report and Recommendations on Taxpayer Compliance*, 41 TAX LAW. 329, 334 (1988); Nina E. Olson, National Taxpayer Advocate before the Senate Comm. on Finance on the Tax Gap and Tax Shelters (July 21, 2004), reprinted at Tax Doc. 2004-14941; James Andreoni, Brian Erard & Jonathan Feinstein [BB 16.1, ex. 3], *Tax Compliance*, 36 J. ECON. LIT. 818, 819 (1998); Eric Toder, *What Is the Tax Gap?*, 117 TAX NOTES 367 (Oct. 22, 2007).

[11] *But see* RANDOLPH E. PAUL, TAXATION FOR PROSPERITY 277 (1947) (quoting Oliver Wendell Holmes, "I like to pay taxes. With them I buy civilization."); Chuck O'Toole, *Tax Us More, Says Group of Wealthy Activists*, TAX NOTES TODAY (August 20, 2009).

[12] *See* Janet Novack, *Are You a Chump*?, FORBES Mar. 5, 2001, at 122 (suggesting that a taxpayer was a chump if they paid their taxes without using tax shelters.); *see also* IRS OVERSIGHT BOARD ANNUAL REPORT, at 2 (2002), *available at* http://treas.gov /irsob/reports/2001_annual_report.pdf ("The Oversight Board is concerned that the broad decline in enforcement activity increases our reliance on voluntary compliance, and fears that the public's attitude towards voluntary compliance is beginning to erode."); *IRS Oversight Board, Testimony Before the Joint Comm. on Taxation: Joint Hearing on the Strategic Plans and Budget of the IRS*, 107th Cong. 2 (May 14, 2002) (statement of Larry Levitan, Chairman); Alison Bennett, *IRS Compliance Activity Increasing but Audit Rates Rising Slowly, Data Show*, DAILY TAX REP. (BNA), at GG-1 (Mar. 21, 2003); James M. Bickley, *CRS Updates Report on Tax Gap, Enforcement*, TAX NOTES TODAY, at 1 (Feb. 26, 2008). ("Other motivations for reducing the tax gap include adverse effects on (1) public trust in the fairness of the tax system, which may adversely affect voluntary compliance with the tax laws . . ."); Steve Johnson, *The 1998 Act and the Resources Link Between Tax Compliance and Tax Simplification*, 51 U. KAN. L. REV. 1013, 1014 (2003) (noting that a loss of public confidence in the tax system will lead to a decline in

lieve that it is every American's civic and moral duty to pay the taxes that they are legally obligated to pay.[13]

Although the above state of affairs is not new, this year the IRS has announced a radical and far-reaching compliance initiative for certain large corporate taxpayers. In this regard, certain large corporate taxpayers will now be required to complete a new disclosure schedule as part of their federal income tax return. In this new disclosure schedule (called "Schedule UTP"), the taxpayer is required to separately disclose and describe each uncertain tax position contained in the taxpayer's income tax return.[14] Thus, after the taxpayer signs the face of the income tax return where the taxpayer swears that the information contained in the return is true, accurate, and complete, the taxpayer will be required to affirmatively disclose on the attached Schedule UTP all of the "soft spots" contained in the taxpayer's income tax return.[15] This new Schedule UTP disclosure requirement represents an important new chapter in the self-assessment requirements imposed on taxpayers under the country's income tax laws.

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self-assessments—i.e., voluntary compliance).

[13] In response to the statement "it is every American's civic duty to pay their fair share of taxes," 94% of the individuals surveyed in the 2010 Taxpayer Attitude Survey responded that they either "Completely Agree" (70%) or "Mostly Agree" (25%). INTERNAL REVENUE SERVICE OVERSIGHT BOARD, 2010 TAXPAYER ATTITUDE SURVEY 4, *available at* http://www.treas.gov/IRSOB/board-reports.shtml. Similarly, 81% of the respondents identified personal integrity as providing "[a] great deal of influence" on their tax compliance. *Id.* at 7.

[14] The disclosure requirements of new Schedule UTP are discussed in Section III.A., *infra*.

[15] Although Schedule UTP represents a radical departure from prior tax reporting practice, the concept of having such a requirement is not new. The idea was publicly announced in a speech to the American Institute of Certified Public Accountants on May 24, 1977 by then IRS Commissioner Jerome Kurtz, as set forth in the following excerpt from that speech:

> I believe taxpayers, especially sophisticated taxpayers, and their preparers should be required to report on their returns "questionable" positions that have been taken on the return. By "questionable" I mean essentially a position that is knowingly inconsistent with published regulations, rulings or cases. The kind of position that accountants reserve against . . . .

See IRS News Release, "Remarks of Jerome Kurtz Commissioner of IRS Before The American Institute of Certified Public Accountants, Los Angeles, California" (May 24, 1977). This proposal created a firestorm of controversy through the remainder of 1977 and into 1978. *See, e.g., Discussion on "Questionable Positions:" Commissioner Jerome Kurtz and Pane*l, 32 TAX LAW. 13, 13 (1978); *AICPA Representatives Talk With IRS Commissioner Jerome Kurtz*, 144 J. OF ACCT. 42, 42, 44–48 (1977). IRS Commissioner Kurtz announced his proposal at a time when the IRS sought tax accrual workpapers from accounting firms to aid in tax audits, and this effort to obtain tax accrual workpapers created its own further firestorm of controversy. *See, e.g.,* Mortimer M. Caplin, *Should the Service Be Permitted to Reach Accountants' Tax Accrual Workpapers?*, J. TAX'N., Oct. 1979, at 194, 194. Mortimer M. Caplin, *IRS Toughens its Stance on Summoning Accountants' Tax Accrual Workpapers*, J. TAX'N., Sept. 1980, at 130, 130. *I.R.S. Eyes Accountants*' Workpapers, 67 A.B.A. J. 1703 (1981); Note, *Government Access to Corporate Documents and Auditors' Workpapers: Shall we Include Auditors Among the Privileged Few?*, 2 J. CORP. L. 349, 351–52 (1977). As will be explored further in Section II of this article, today's environment has been remarkably more conducive to current IRS Commissioner Schulman's proposal because the corporate governance reforms of the past last decade have fundamentally changed the underlying expectations of compliance and expectations of transparency for taxpayers and their tax advisors. Thus, it is an important insight to recognize that IRS Commissioner Kurtz's original proposal received a hostile reception in 1978 and was not implemented at that time whereas current IRS Commissioner Schulman's reintroduction of this same proposal at the beginning of 2010 was implemented in rapid fashion within a year. In addition to representing a testament to the tax community's acknowledgement of the heightened transparency expectations of today versus the past, this historical record also represents a testament to the rapidity in which change is being implemented in today's tax practice versus the past.

However, before proceeding with an analysis of the implications of the new affirmative disclosure requirements contained in Schedule UTP, it is helpful to review the impetus for these new compliance requirements. In this regard, somewhat surprisingly, the catalyst for this new disclosure schedule has been driven by the transparency and corporate governance reforms that were implemented for nontax reasons. Therefore, Section II of this article sets forth a brief review of these corporate governance reforms. This is helpful in order to correctly understand the background for the changes that are being demanded in today's tax practice. After this review, Section III sets forth a detailed discussion of the new disclosure requirements implicated by new Schedule UTP. Section IV sets forth an analysis of another transparency reform involving whistleblower awards and discusses how those reforms interrelate with the new Schedule UTP disclosure requirements. Section V sets forth a prediction of what further reforms are reasonably foreseeable. Finally, Section VI sets forth some concluding thoughts about the overall impact that these recent initiatives will have on the tax community and how taxpayers should respond.

II. CORPORATE GOVERNANCE AND TRANSPARENCY REFORMS

In the fall of 2001, Congress and regulatory agencies faced a crisis in public confidence with respect to the financial reporting of public companies. This crisis was fueled by the financial collapse of Enron, WorldCom, Adelphia, and Tyco. The common denominator for each of these high-profile corporate failures was the fact that the publicly-filed financial statements for each of these companies did not adequately disclose to the user of the financial statements the nature of the risks that were imminent nor did the internal controls for each of these companies warn management of the inadequacy of their public disclosures.[16]

In response, Congress and regulatory bodies acted aggressively to institute sweeping reforms.[17] One important early response to restore public confidence in the financial reporting of public companies was the enactment of the Sarbanes-Oxley Act of 2002 ("SOX").[18] In an effort to reinforce the seriousness of the financial reporting of public companies, SOX section 404 and section 302 require the principal executive officer and the principal financial officer to certify under penalties of perjury that the company's financial statements are reliable and that the company's internal controls are effective. In addition, the company's external auditor must give its opinion as to management's assessment of the effectiveness of the company's internal controls,[19] and this auditor attestation must be done in conjunction with the overall audit of the

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[16] Edward J. Janger, *Brandeis, Business Ethics, and Enron*, *in* ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS 63, 63 (Nancy B. Rapoport & Bala G. Dharan eds., Foundation Press 2004).

[17] Troy A. Paredes, *Enron: The Board, Corporate Governance, and Some Thoughts on the Role of Congress, in* ENRON: CORPORATE FIASCOS AND THEIR IMPLICATIONS 495, 515 (Nancy B. Rapoport & Bala G. Dharan eds., Foundation Press 2004).

[18] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 [hereinafter SOX].

[19] *See id.* § 404(b); Policy Statement Regarding Implementation of Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*, PCAOB Release 2005-009, (May 16, 2005), *available at* http://pcaobus.org/Rules/Rulemaking/Docket008 /2005-05-16_Release_2005-009.pdf.

company's financial statements.[20]

When the principal officer states that the company's internal controls over financial reporting are effective, the principal officer is stating that no material weaknesses exist.[21] A material weakness in internal controls is a deficiency, or combination of deficiencies, that results in a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.[22] A deficiency in internal control includes both deficiencies in design and operation.[23] Thus, in order for management to make the certification required by SOX section 302 and section 404, the company must assess both the design of its internal controls and the operating effectiveness of those internal controls.[24] The objective of these internal control assessments is to provide management with reasonable assurance that its internal controls operate effectively to ensure the reliability of the company's financial reporting.[25]

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[20] Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements, PCAOB Release No. 2007-005A at 5 (June 12, 2007).

[21] *Id.* ¶ 2.

[22] *Id.* ¶ A7. PCAOB Auditing Standard No. 5 superseded PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Conducted in Conjunction With an Audit of Financial Statements* (June 2004), effective for fiscal years ending on or after Nov. 15, 2007. PCAOB Auditing Standard No. 5's definition of "material weakness," however, is effective on issuance, June 12, 2007. PCAOB retained the existing framework for evaluating deficiencies under which material weaknesses are identified by assessing the likelihood and magnitude of a potential misstatement, but changed the likelihood from *more than remote* to *reasonably possible*, and increased the magnitude by making a material weakness as more severe than a significant deficiency. PCAOB Auditing Standard No. 2, ¶ 10, defined a *material weakness* as equal to "a *significant deficiency*, or combination of significant deficiencies, that results in *more than a remote likelihood* that a material misstatement of the annual or interim financial statements will not be prevented or detected" (italics added). PCAOB Auditing Standard No. 5, however, does not equate a significant deficiency with a material weakness. Section A11 defines significant deficiency is "a deficiency, or combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company's financial reporting." The SEC defines the term significant deficiency in the same manner as the PCAOB. 17 C.F.R. § 240.12b-2 (2009); *see also* Definition of the Term Significant Deficiency, Definition of the Term Significant Deficiency, SEC Release No. 33-8829 (Sept. 10, 2007).

[23] PCAOB Auditing Standard No. 5, *supra* note 20, ¶ A3, states, "A deficiency in internal control over financial reporting exits when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A deficiency in *design* exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met. A deficiency in *operation* exists when a properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority or competence to perform the control effectively."

[24] *See*, SIMON M. LORNE ET AL., INTERNAL CONTROLS: SARBANES-OXLEY ACT § 404 AND BEYOND (PORTFOLIO 5402) (2006).

[25] 15 U.S.C. § 78m(b)(7) (2002). The SEC staff stated, "While 'reasonableness' is an objective standard, there is a range of judgments that an issuer might make as to what is 'reasonable' in implementing Section 404 and the Commission's rules . . . Different conduct, conclusions and methodologies by different issuers in a given situation do not by themselves mean that implementation by any of those companies is unreasonable." DIV. OF CORP. FIN. OFFICE OF THE CHIEF ACCOUNTANT U.S. SECS. & EXCH. COMM., STAFF STATEMENT ON MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING, § C (May 16, 2005), *available at* http://www.sec.gov/info/ accountants/stafficreporting.htm.

Furthermore, in order to demonstrate that management's assessment was reasonable, the SEC advised companies that they must maintain documentary evidence to substantiate the basis for management's conclusion that the company's internal controls are effective.[26] In order to satisfy this documentation requirement, companies have expended considerable effort to document the design of their internal controls and then have expended considerable effort to document the actual operating effectiveness of those controls.[27]

Another outgrowth of this same effort to restore public confidence came from the issuance of Financial Interpretive Statement 48 ("FIN 48") by the Financial Accounting Standards Board.[28] The FASB stated that the issuance of FIN 48 would result in increased relevance and comparability in financial reporting of income taxes. The FASB had become concerned that a diversity of practice had developed with respect to the financial statement reporting of tax exposures related to uncertain tax positions that had been taken on a company's tax return.[29] To reduce such diversity, FIN 48 sets forth criteria for the recognition, derecognition, measurement, classification, and disclosure of the financial impact of a company's income tax positions.[30] In terms of recognition, FIN 48 prescribes the following two-step process:

> 1. Recognition: The company must determine whether a tax position is more-likely-than-not to be sustained upon examination.[31]
>
> 2. Measurement: If a tax position meets the more-likely-than-not recognition standard, then the amount of a benefit to be recognized on the company's financial statements is **the largest amount** of the estimated benefit that has a greater than 50% likelihood of being realized.[32]

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[26] 17 C.F.R. § 240.13a-15(c) (2010); Final Rule: Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Release No. 33-8238 (June 5, 2003); 17 C.F.R. § 229.308(c) (2010) Instruction to Item 308, 2.

[27] *See* ERNST & YOUNG, EMERGING TRENDS IN INTERNAL CONTROL 5 (Sept. 2005) (stating that for 70% of companies that the Section 404-related costs were over 50% higher than original estimates); DELOITTE & TOUCHE LLP, *UNCERTAINTY IN INCOME TAXES: A ROADMAP TO APPLYING INTERPRETATION 48*, 5 (2007), *available at* http://www.deloitte.com/dtt/cda/doc/content/us_assur_ Roadmap FIN48a.pdf (discussing need for thorough review of policies, procedures, and documentation and, where necessary, revise its documentation to include a thorough description of the internal controls involved in the identification, evaluation, and reporting of all material tax positions).

[28] *See, e.g.*, ACCOUNTING FOR UNCERTAINTY IN INCOME TAXES, FASB Interpretation No. 48, summary (Fin. Accounting Standards Bd. 2006) [hereinafter FIN 48], *available at* http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175820931560&blobheader=application%2Fpdf. Under the codification of accounting standards, the relevant portions of FIN 48 are now contained in Accounting Standards Codification subtopic 740-10, Income Taxes. *See* FASB Accounting Standard Codification § 740-10 (Fin. Accounting Standards Bd. 2009). Because the industry is more conversant with the FIN 48 nomenclature, this article continues to refer to this pronouncement as FIN 48 and not ASC 740-10.

[29] *Id.* ¶ 1.

[30] *Id.* ¶ 2.

[31] *Id.* ¶ 6.

[32] *Id.* ¶ 8.

If the company believes that it is more-likely-than-not entitled to the tax benefits of a tax position in the amount claimed on the tax return, then the company must claim a financial statement benefit for the full amount of the tax benefit and no footnote disclosure is required. If the company determines under FIN 48's criteria that it has claimed tax benefits on a tax return that are not sustainable in full, then FIN 48 requires the company to not claim a financial statement benefit to this extent and must disclose the aggregate financial impact of its unsustainable tax benefits in a tabular schedule in the footnotes to its financial statements.[33] Even though the tabular disclosure required by FIN 48 is made on an aggregate basis, FIN 48 requires the company to employ a separate, issue-by-issue evaluation for each of its uncertain tax positions in order to determine the aggregate financial impact of its unsustainable tax positions.[34] Thus, FIN 48 makes clear that the more-likely-than-not recognition threshold is a positive assertion that the company believes that it either is entitled, or is not entitled, to the economic benefits associated with each individual tax position.[35]

In order to demonstrate the basis for its conclusions with respect to each of its uncertain tax positions, a company will often obtain legal opinions from attorneys that evaluate the company's uncertain tax positions. These documents, inclusive of the legal opinions that address the sustainability of a company's uncertain tax positions, are generally known in the industry as a company's "FIN 48 tax accrual workpapers."[36] Although the FASB stopped short of requiring management to obtain an outside tax opinion for each uncertain tax position that the company identified, the FASB did recognize that obtaining an outside tax opinion represents evidence supporting management's conclusion. It can also serve to document the diligence efforts that management conducted in order to conclude on whether to recognize a tax benefit for a tax position.[37]

Furthermore, it is important to remember that FIN 48 must be complied with in the context of the rigorous certification and attestation requirements of SOX section 302 and section 404, and those requirements mandate that the company create written documentation to substantiate the basis for its FIN 48 conclusions.[38] Thus, the challenge for taxpayers and their tax advisors has been to document the basis for the company's conclusion regarding whether an uncertain tax position is sustainable, or whether the uncertain tax position fails to meet FIN 48's two-part more-likely-than-not recognition and measurement standards. This FIN 48 documentation is required in order to substantiate in a transparent way that the company's internal processes for making subjective tax decisions are operating effectively.

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[33] *Id.* ¶ 21(a). For ease of discussion, this paper refers to the portion of a tax position that fails to meet the "more-likely-than-not" tests set forth in FIN 48 as "unsustainable." The author believes it is appropriate to refer to these as unsustainable because they are in the company's own judgment, unlikely to be sustained if all of the facts were known.

[34] *See* FIN 48, *supra* note 27, ¶¶ 4-5, Appendix B ¶¶ B13-B14. FIN 48 uses the term "unit of account" and states that each individual "unit of account" must be separately analyzed.

[35] *Id.* ¶ 6.

[36] HANNA, MARTIN, DONOHUE, LEIGHTMAN, & LOWELL, CORPORATE INCOME TAX ACCOUNTING 12.03 (WG&L 2007).

[37] FIN 48, *supra* note 28, Appendix B ¶B34 (stating that FASB recommends that management should decide whether to obtain a tax opinion after evaluating the weight of all available evidence and the uncertainties of the applicability of the relevant statutory or case law).

[38] *See supra* note 21, at 2.

The combined effect of the enactment of SOX and the issuance of FIN 48 has been to require the creation of written documentation with respect to a company's uncertain tax positions. Companies now have detailed documentation on an issue-by-issue basis for each uncertain tax position and must document why they believe their tax positions are unsustainable before they can establish a financial statement reserve. Tax departments no longer have "cookie jar" reserves that represent a general overall reserve. The income tax reserve of today represents an issue-by-issue, bottom-up, reserve analysis. Furthermore, no income tax reserve is allowed under FIN 48 unless the taxpayer believes that the taxpayer will not sustain a tax position in full with respect to a particular issue. In order to promote greater disclosure to financial statement users, the FASB decided that it was important for the company to disclose in its financial statement footnotes the aggregate financial statement impact of the company's unsustainable tax positions.[39]

The financial community and the public have quickly grasped the import of these new footnote disclosures. For example, one equity research report published in 2007 reviewed 361 companies in the S&P 500 that had adopted FIN 48. In their analysis, they found that sixty-two companies had each claimed over $500 million of tax benefits from unsustainable tax positions, and thirty-six of those companies had claimed over $1 billion of tax benefits from unsustainable tax positions.[40] The top ten companies with the largest unrecognized tax benefits had claimed a combined $46 billion of tax benefits for positions that in their own self-assessment were not sustainable. This report then attempted to develop a "tax risk report card" where the financial impact of each company's unrecognized tax benefits was compared to the overall market capitalization of the company. This report indicated that "the new disclosures in FIN 48 take the guess work out of trying to get your arms around a company's uncertain tax positions and the tax reserves it has taken against them."[41] Now that FIN 48 has taken away the guesswork, the public sees that the largest companies and the most sophisticated taxpayers openly admit that they have claimed significant tax benefits that they do not believe are sustainable. Another report, prepared with data as of June 15, 2010, found that the 500 largest US public companies claimed in combination over $200 billion of tax benefits that in their own self-assessment were unsustainable.[42] The largest claims of unsustainable tax positions were as follows:

Table: FIN 48 Self Disclosures of Tax Owed But Not Paid n		
	Company	Amount
1.	GE	$8.7 billion
2	Pfizer	$7.6 billion
3	AT&T	$7.5 billion
4	JP Morgan	$6.6 billion
5	General Motors	$5.4 billion
Total of Top 500		~$200 billion

[39] FIN 48, *supra* note 28, Appendix B ¶B63.

[40] David Zion and Amit Varshney, *Peeking Behind the Tax Curtain* Credit Suisse at 8 (May 18, 2007).

[41] *Id.* at 13.

[42] *Ferraro 500 – Uncertain Tax Positions*, 2010 TNT 170 – 36, Doc. 2010-19374 (September 2, 2010).

Yet, after making these self-declarations that these companies believe in their own judgment that they have claimed tax positions that are not sustainable, these companies continue to claim these unsustainable tax positions on their tax returns even though the company has come to a positive assertion that they are not sustainable in their own judgment. When a taxpayer and its advisors take a tax return position that is not sustainable (and which the taxpayer does not reasonably believe is sustainable), the government's efforts to collect the right amount of tax in a timely manner are frustrated. The adoption of FIN 48 has revealed the scope of the tax gap related to this current tax filing practice, and this transparency has in turn created the impetus for Schedule UTP.[43]

III. NEW SCHEDULE UTP: REPORTING REQUIREMENTS AND IMPLICATIONS

Through a series of announcements, proposed regulations, and final regulations,[44] the IRS established a new reporting requirement for certain large companies to affirmatively disclose their uncertain tax positions on new Schedule UTP. On January 26, 2010, the IRS first announced this new initiative to require taxpayers to affirmatively highlight the "soft spots" in their own tax returns through its issuance of Announcement 2010-9, 2010-7 IRB 408. On April 19, 2010, the IRS issued Announcement 2010-30, 2010-19 IRB 668, which in turn set forth an initial draft Schedule UTP and accompanying instructions for completing this new disclosure schedule. On September 24, 2010, after considering a number of taxpayer comments, the IRS issued Announcement 2010-75, 2010-41 IRB 428 in order to set forth the taxpayer disclosure requirements for completing final Schedule UTP. For clarity, this article refers to the draft version of Schedule UTP and its draft instructions that were released on April 19th concurrently with Announcement 2010-30 as the "draft Schedule UTP" while the later final version of Schedule UTP and its final instructions that was released on September 24th concurrently with Announcement 2010-75 is referred to as the "final Schedule UTP."

A. Analysis of Schedule UTP Reporting Requirements

The final Schedule UTP and its instructions generally apply to certain large companies that issue audited financial statements and make their tax filings on Form 1120, Form 1120-F, Form 1120-L, or Form 1120-PC. However, in response to various public comments,[45] the IRS implemented a five-year phase-in period for final Schedule UTP for corporations with

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[43] Coder, Jeremiah, *UTP Reporting Grew Out of Changes in Accounting Requirements, Wilkins Said*, Tax Notes Today (Tax Analysts), Doc. 2010-2400 (November 9, 2010), *available at* LEXIS 2010 TNT 216-6. One important caveat, however, is that the tax disclosure includes US federal income, state income, and non-US income tax exposures. Thus, the financial statement disclosure may represent amounts attributable to more than just US federal income tax issues.

[44] Announcement 2010-75, 2010-41 I.R.B. 428; Announcement 2010-30, 2010-19 I.R.B. 668; Announcement 2010-17, 2010-13 IRB 515; Announcement 2010-9, 2010-7 I.R.B. 408; Notice of Proposed Rulemaking and Notice of Public Hearing, REG-119046-10; 75 F.R. 9754 (September 9, 2010); T.D. 9510, Fed. Reg. Doc. 2010-31576 (December 15, 2010); Treas. Reg. §1.6012-2(a)(4) through (5) (2010).

[45] *See, e.g.*, Lisa G. Workman, *CPA Firm Raises Concerns About Proposal to Require Reporting of Uncertain Tax Positions*, Tax Notes Today (Tax Analysts), Doc. 2010-12415 (May 21, 2010), *available at* LEXIS 2010 TNT 109-20.

total assets of under $100 million. In this regard, Announcement 2010-75 provides that corporations that have total assets equal to or exceeding $100 million must file Final Schedule UTP starting with their 2010 tax year. The announcement goes on to state that this total asset threshold will be reduced to $50 million starting in 2012 and then further reduced to $10 million starting in 2014. Announcement 2010-75 indicates that the IRS is still considering whether and to what extent it should extend the final Schedule UTP reporting requirements to other taxpayers. The final Schedule UTP and its instructions do not exclude taxpayers in the Compliance Assurance Program ("CAP"),[46] nor does it exclude taxpayers who are under continuous audit. But, the IRS did say in Announcement 2010-75 that further guidance for CAP taxpayers is expected to be forthcoming shortly.

Announcement 2010-75 makes clear that an uncertain tax position includes all of the taxpayer's uncertain tax positions for which the taxpayer has created a tax reserve on its financial statements by reason of FIN 48. The final instructions clarify that the final Schedule UTP seeks the reporting of tax positions consistent with the financial statement reserve decisions made by the corporation.[47] In response to several comment letters,[48] the instructions now clarify that corporations are not required to report uncertain tax positions that are either immaterial under applicable financial accounting standards or are sufficiently certain so that no reserve is required under financial accounting standards. In addition, the instructions to final Schedule UTP make clear that an uncertain tax position must be disclosed even if no financial statement reserve is created for the position when the taxpayer expects to litigate the issue with the IRS.

The draft Schedule UTP originally had proposed that the taxpayer must report an estimated maximum tax adjustment amount for each uncertain tax position listed on Schedule UTP other than transfer pricing and valuation uncertainties. This initial proposal received considerable comment from the public,[49] and after considering those comments the IRS in Announcement 2010-75 removed the requirement to report a maximum tax adjustment amount. Instead, the instructions to final Schedule UTP now require a corporation to rank all of its uncertain tax positions (including transfer pricing and other valuation positions) based on the United States federal income tax reserve (including interest and penalties) recorded for the position taken in the return. The instructions also require the taxpayer to designate the tax posi-

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[46] *See* Announcement 2005-87, 2005-2 C.B. 1144 (Under the Compliance Assurance Program, the IRS works with large business taxpayers to identify and resolve issues prior to the filing of a tax return. The objective of the program is to reduce taxpayer burden and uncertainty while assuring the IRS of the accuracy of tax returns prior to filing, thereby reducing or eliminating the need for post-filing examinations. The Compliance Assurance Program requires extensive contemporaneous exchange of information).

[47] *See id.* For a discussion of several unresolved reporting questions with respect to reporting of pre-existing uncertain tax positions for affiliates that enter or leave a consolidated group, see Peter H. Blessing, N.Y. State Bar Ass'n Tax Section, *NYSBA Tax Section Report Addresses Uncertain Tax Positions in Mergers, Acquisitions, Spinoffs*, Tax Notes Today (Tax Analysts) Doc. 2010-27092 (Dec. 20, 2010), *available at* LEXIS 2010 TNT 244-17.

[48] Am. Bankers Ass'n et al., *Business Groups Take Issue With Uncertain Tax Position Proposal*, Tax Notes Today (Tax Analysts) Doc. 2010-12641 (June 1, 2010), *available at* LEXIS 2010 TNT 110-21.

[49] *See*, *e.g.,* Comment Letter by American College of Tax Counsel, Tax Doc. 2010-13688, 2010 TNT 119-19 (June 22, 2010); Comment Letter by Skadden, Arps, Meagher & Flom LLP, Tax Doc. 2010-13639, 2010 TNT 119-20 (June 22, 2010); Comment Letter by Ernst & Young LLP, Tax Doc 2010-12740, 2010 TNT 111-30 (June 10, 2010).

tions for which a reserve for the particular tax position exceeds 10 percent of the aggregate amount of the financial statement reserves established for all of the tax positions reported on final Schedule UTP. In response to several public comments[50] with respect to tax positions for which no reserve was created based on an expectation to litigate the position, the final instructions to final Schedule UTP now provide that no exposure size or ranking needs to be indicated with respect to these uncertain tax positions.

In the draft Schedule UTP, the IRS had proposed that taxpayers explain why an uncertain tax position was uncertain and also proposed that taxpayers explain the nature of the uncertainty. This required explanation created considerable public comment about whether this disclosure would cause the taxpayer to make party admissions or waive subject matter privilege.[51] In response to those concerns, the instructions to final Schedule UTP eliminates this requirement and affirmatively states that a taxpayer need not assess the hazards of an uncertain tax position.[52] Instead, the instructions to final Schedule UTP now require taxpayers to only provide a concise description of the tax position that reasonably can be expected to apprise the Service of the identity of the tax position and the nature of the issue. [53]

Several commentators asked the IRS to confirm that a taxpayer's right to claim privilege would not be impacted by the taxpayer's completion of final Schedule UTP.[54] Instead of doing so, the IRS issued a separate announcement where it indicated that the government would generally extend its "policy of restraint" at the IRS examination level to final Schedule UTP workpapers.[55] In this regard, Announcement 2010-76 stated that the IRS would forgo seeking production of documents that relate to the completion of final Schedule UTP and stated that taxpayers may exclude from any request for taxpayer reconciliation workpapers any working drafts, revisions, or comments concerning the concise description of tax positions re-

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[50] Comment Letter by Ernst & Young of Financial Executive International, Tax Doc. 2010-12653, 2010 TNT 111-25 (June 10, 2010).

[51] Walter A. Pickhardt, Minn. Bar Ass'n Tax Section, *Minnesota State Bar Association Tax Section Comments on Proposed Regs to Implement UTP Reporting*, Tax Notes Today (Tax Analysts) Doc. 2010-21031 (Sept. 17, 2010), *available at* LEXIS 2010 TNT 187–24.

[52] *See* I.R.S. Announcement 2010-75, 2010-41 I.R.B. 428, 429; IRS, *supra* note 65, at 1–2.

[53] *Id.*

[54] *See, e.g.*, George M. Gerachis & Christine L. Vaughn, Vinson & Elkins LLP, *Attorneys Suggest Changes to UTP Reporting Proposal*, Tax Notes Today (Tax Analysts) Doc. 2010-12674 (June 1, 2010), *available at* LEXIS 2010 TNT 111-26.

[55] Announcement 2010-76, 2010-41 I.R.B. 432 (October 12, 2010). The IRS "policy of restraint" was first developed in the 1980s. After prevailing in its right to seek tax accrual workpapers in the *Arthur Young* case, the IRS became concerned that there would be a legislative response that might curtail the scope of the IRS victory in that judicial decision. To forestall a potential legislative response, the IRS announced that it would generally not seek tax accrual workpapers from taxpayers. *For the initial guidance setting forth the initial formulation of the IRS "policy of restraint," see* I.R.S. News Release IR-81-49 (May 5, 1981); *see also* I.R.S. Announcement 84-46, 1984-18 I.R.B. 18 (announcing that in response to the *Arthur Young* decision, the Service would not alter its current procedures for requesting tax accrual workpapers relating to the evaluation of a corporation's reserves for contingent tax liabilities). However, the legislative environment today is not favorable for further protections from discover because the Congressional mood from both political parties supports efforts to reduce the nation's tax gap. *See, e.g.,* authorities cited in note 8, *infra*.

ported on final Schedule UTP.[56] However, this separate announcement also indicated that the IRS's restraint does not create or imply any change in the government's understanding of the application of the attorney-client privilege, the tax advice privilege under section 7525, or of the attorney work product doctrine.[57] In a public statement, the IRS Commissioner stated that disclosures made on final Schedule UTP that are consistent with the revised guidelines set forth for final Schedule UTP do not constitute a waiver of privilege over the subject matter of the uncertain tax position,[58] but this legal conclusion is not found in the text of Announcement 2010-76 and in fact the preamble to final Treasury regulations explicitly refused to provide any such concession.[59] As a result, taxpayers are likely to remain concerned about whether their completion of final Schedule UTP represents a waiver of privilege with respect to the matters affirmatively disclosed on final Schedule UTP. The issues surrounding privilege are considered more fully as a discrete subtopic in this article in Section V.C., *infra*.

The instructions to final Schedule UTP clarify that corporations need only report their own tax positions and need not report the tax positions of a related party. The instructions to final Schedule UTP also clarify that tax positions taken in years before 2010 need not be reported on final Schedule UTP even if a reserve is recorded in audited financial statements issued in 2010 or later.[60]

At least one comment letter[61] indicated that a liberal disclosure of final Schedule UTP to non-US tax officials could create extraterritorial waiver issues in non-US jurisdictions. Perhaps due to this comment letter, the IRS stated that it intends to generally refrain from providing final Schedule UTP information to other governments except in those circumstances in which there is a reciprocal exchange of information agreement.[62] In addition, even if reciprocity did exist, the Service would consider other factors in determining whether to disclose the information, including the relevance of the information to the foreign government.

B. Analysis of Why Taxpayers Should Fully Complete Schedule UTP

The requirement to complete final Schedule UTP brings several potential reactions, but an analysis of each of these reactions leads one to believe that in the end taxpayers are likely to believe that their safest (and really only practical) course of conduct will be to fully complete final Schedule UTP, to disclose all uncertain tax positions for which the company has taken a financial statement reserve, and to disclose uncertain tax positions that the IRS has is-

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[56] Announcement 2010-76, 2010-41 I.R.B. 432 (October 12, 2010).

[57] *Id.*

[58] I.R.S News Release 2010-98, Prepared Remarks of IRS Commissioner Doug Shulman to the American Bar Association, Toronto, Canada (September 27, 2010), *reprinted at* Tax Doc. 2010-20927, 2010 TNT 186-30.

[59] *See* T.D. 9510, Fed. Reg. Doc. 2010-31576 (December 15, 2010).

[60] *See* IRS Large Business & International, Frequently Asked Questions on Schedule UTP, Q&A #3, available at *http://www.irs.gov/businesses/article/0,,id=237538,00.html, reprinted at* 2011 TNT 57-1, Doc. 2011-6154 (March 3, 2011).

[61] Comment Letter by Paul Seraganian of Osler, Hoskin & Harcourt LLP, Tax Doc. 2010-12201, 2010 TNT 107-23 (June 4, 2010).

[62] Announcement 2010-76, 2010-41 I.R.B. 432 (October 12, 2010).

sued guidance to the tax community that it intends to litigate. A current treatise provides the following wise practical advice:

> "In our view, the traditional tax planning and dispute resolution model of adopting aggressive positions, sitting back to see if the tax authorities raise any serious issues, and then proceeding to IRS Appeals and litigation if such issues arise is outdated and unworkable in today's world of transparency. The reality today is that tax positions will be examined by the company's auditor, and possibly disclosed in its financial statements, which, in turn, will result in a much higher likelihood that the IRS will review these matters. As such, companies are better served to assume that their tax positions, aggressive or routine, will be reviewed by the IRS, including all associated workpapers and opinion materials. In our view, the overall policy of the company should be one of open disclosure which will, in turn, create a collaborative work environment with the IRS."[63]

As the following discussion indicates, the IRS has sufficient enforcement mechanisms to ensure that taxpayers fully complete Schedule UTP and conduct their tax reporting in a transparent manner. Furthermore, it is reasonable to expect that further reforms could well be in place before the audit of the 2010 tax returns, and the risk of these reforms should cause taxpayers to avoid noncompliance. The thought process for reaching the conclusion that taxpayers should decide to fully complete Schedule UTP and avoid "hiding the ball" is set forth below.

i. Not Disclosing All Uncertain Tax Positions Creates Unacceptable Risk.

From a tax perspective, taxpayers may have an initial desire to not record financial statement reserves in order to avoid making affirmative disclosures on final Schedule UTP, but actually following through on this initial desire is fraught with risk. The failure to have appropriate internal controls in place to assure that a company has appropriately assessed and evaluated the firm's subjective risks can represent a material weakness in the company's internal controls. An intentional failure in internal controls implicates a range of potential sanctions that can create personal exposure to the Chief Financial Officer and to the Chief Executive Officer.[64] The public disclosure obligations with respect to reporting material weakness to shareholders and the corrective actions to remediate those weaknesses make this possible response unpalatable to most companies and to their board of directors. Furthermore, the company's external financial auditor will have its own motivation to ensure that its audit clients do not understate or misstate their financial statement reserves because the external auditor must give its own opinion with respect to the operating effectiveness of the company's internal controls over subjective tax decisions. In addition, if a person were to attempt this course, then that person must set forth the substantive basis for reaching this decision in written form. In today's SOX environment, this person would need to obtain multiple sign-offs within the company and from the company's external financial auditors. Thus, the corporate governance and transparency reforms that have occurred over the last decade will make this response a risky and unsat-

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[63] Hanna, Martin, Donohue, Leightman, & Lowell, CORPORATE INCOME TAX ACCOUNTING, at 12.03 (WG&L 2007).

[64] SOX §906(c)(1) (prison sentence of up to ten years).

isfactory response. Hence, this author believes that it is unlikely that companies subject to SOX would actually follow through on this course of action.

A second potential response is that a taxpayer would simply not complete final Schedule UTP. In this event, §7203 of the Internal Revenue Code theoretically could impose criminal penalties for failure to properly complete final Schedule UTP, but as has been pointed out by another commentator it is often difficult for the IRS to prove ''willful failure."[65] With this said, another effective remedy available to the IRS in this situation would be for it to further rescind its "policy of restraint" with respect to taxpayers that report tax reserves on their financial statements, but fail to provide an adequate disclosure of them on final Schedule UTP.

A precedent for this sort of a governmental response exists with the evolution of the administrative practice related to listed transactions. In Notice 2000-15, 2001-1 C.B. 826 (February 29, 2000), the IRS gave its initial administrative guidance with respect to the types of transactions that must be disclosed in the tax return as "listed transactions."[66] In 2002, two years after giving guidance as to the types of transactions that should affirmatively be disclosed on the tax return, the IRS announced that it would modify its policy of restraint and request tax accrual workpapers if the IRS became aware that the taxpayer had engaged in listed transactions.[67] Announcement 2002-63 went on to state that if the taxpayer affirmatively had disclosed the listed transaction on their tax return as required by Temp. Treas. Reg. §1.6011-4T, then the IRS would routinely request the tax accrual workpapers of the taxpayer that **pertained only** to the listed transaction. However, Announcement 2002-63 then stated that if the taxpayer had not disclosed the listed transaction on the taxpayer's tax return, then the IRS would routinely request all tax accrual workpapers of the taxpayer **for all issues**. Finally, Announcement 2002-63 stated that if the IRS determined that the taxpayer had engaged in multiple listed transactions, then regardless of whether the listed transactions were disclosed, the IRS may request all of the taxpayer's tax accrual workpapers for all tax issues.

Given this prior precedent, it is foreseeable that taxpayers will find that the IRS audit practice at the time of the audit of their 2010 tax return will no longer provide restraint from seeking FIN 48 workpapers if the taxpayer did not provide adequate information on final Schedule UTP. Said differently, if the IRS cannot get the tax reserve information in the detail that it needs from final Schedule UTP, then it is foreseeable that the IRS will not show restraint with respect to requesting FIN 48 tax accrual workpapers from such taxpayers. Given the strong probability that the IRS audit process will be changed in this way in time for the IRS audit of the 2010 tax year, taxpayers are likely to avoid the risk of this scenario by completing the final Schedule UTP.

As an intermediate course, a taxpayer might instead choose to limit their disclosures of uncertain tax positions on final Schedule UTP to only those issues that the IRS has already

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[65] *See* Harvey, *Schedule UTP: Views of a Former Tax Advisor and Administrator*, 128 Tax Notes 1259, 1260. (September 21, 2010).

[66] The IRS has subsequently updated this list of transactions of interest and the current list of such transactions is set forth in Notice 2009-59, 2009-31 I.R.B. 170 (August 3, 2009).

[67] *See* Announcement 2002-63, 2002-2 C.B. 72.

identified as rollover issues in prior audits. This tactical alternative is also fraught with risk. Similar to the situation where final Schedule UTP is not completed at all, if the IRS suspects that a taxpayer's completion of final Schedule UTP is incomplete, it is foreseeable that the IRS audit practice at the time of the audit of the taxpayer's 2010 tax return will provide the IRS examination team with authority to request the taxpayer's FIN 48 tax accrual workpapers.[68] Given this obvious and predictable scenario, taxpayers are likely to want to fully complete final Schedule UTP so that the taxpayer can assert that the FIN 48 workpapers would not identify any additional tax reserve positions that were not disclosed on final Schedule UTP.

Thus, after reviewing each of the above distasteful outcomes associated with an incomplete disclosure of tax reserves on final Schedule UTP, the likely response from most taxpayers will be that they will disclose all of their uncertain tax positions for which they have established a financial statement reserve. If this is the likely response, then a likely further outcome is that the company's tax department will have substantial internal discussions with senior management about tax positions that require disclosure on final Schedule UTP, and the company's board of directors may also become more interested in being briefed on the uncertain tax positions that require disclosure on final Schedule UTP.[69] This further internal rigor along with the added disclosure of the "soft spots" in the taxpayer's tax return may (in combination) cause taxpayers to become more conservative with respect to the tax positions taken on their tax return. It would be a benefit to the country if taxpayers minimized the instances in which they claimed tax positions that, in their own judgment, are unsustainable.

Another line of inquiry that taxpayers must now go through involves identification of tax positions where the taxpayer expects to prevail through litigation. Again, the IRS has requested disclosure of **sustainable** tax positions when the taxpayer expects to litigate the matter. Thus, the question becomes what criteria the taxpayer should use to determine whether a tax position would require litigation.

In this regard, as a general rule, the Internal Revenue Manual makes it clear that the IRS mission is to collect the right amount of tax, not the maximum amount of tax.[70] Given that the IRS has a stated goal of collecting the right amount of tax, one would expect taxpayers to argue that it is reasonable for them to expect the IRS to not litigate a case where the taxpayer believes there is more than a 50% likelihood of taxpayer success.

An exception to this general approach would exist when the IRS has issued administrative guidance that makes it clear that the government is unwilling to settle a particular tax

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[68] *See* Harvey, *Schedule UTP: Views of a Former Tax Advisor and Administrator*, 128 Tax Notes 1259, 1261 (September 20, 2010).

[69] In an unusual action, the Commissioner of the IRS in several public speeches last year called upon the board of directors to enhance their governance oversight of the company's tax function. *See* Prepared Remarks Of Commissioner Of Internal Revenue Douglas H. Shulman Before The 2009 National Association Of Corporate Directors Corporate Governance Conference Washington, DC, IRS News Release 2009-95 (October 19, 2009); Prepared Remarks Of Douglas H. Shulman George Washington University Law School 22nd Annual Institute On Current Issues On International Taxation Washington, DC, IRS News Release 2009-116 (December 10, 2009). The adoption of final Schedule UTP is likely to trigger the outcome that the Commissioner publicly requested.

[70] I.R.M. 1.1.1.1 (Mar. 1, 2006) (The IRS's role is to help the large majority of compliant taxpayers with the tax law, while ensuring that the minority who are unwilling to comply pay their fair share).

position.[71] In this event, the taxpayer has notice that the government would expect to litigate this particular tax position and thus should be disclosed on final Schedule UTP whether or not the taxpayer believes the tax position is sustainable. If the taxpayer did not disclose these areas of particular IRS interest, then it is reasonable to believe that the IRS would view this omission as a failure to adequately complete final Schedule UTP and may in turn seek the taxpayer's FIN 48 workpapers for all other transactions. Given that this is a foreseeable and predictable governmental response, one would expect that taxpayers would disclose sustainable tax positions that the IRS has designated as positions that it will not settle administratively, but the taxpayer's disclosures may well be limited to these expressed areas of non-settlement. If the IRS wanted a more robust disclosure of sustainable tax positions, then the IRS is likely to need more guidance to elicit a further disclosure.

ii. Concise Description of Issues Should be Forthright

Once a taxpayer identifies the list of uncertain tax positions that will be disclosed on final Schedule UTP, the next decision point for the taxpayer will be to decide on the actual language for setting forth "the concise description of the tax position . . . that reasonably can be expected to apprise the Service of the identity of the tax position and the nature of the issue." Taxpayers need to ensure that their disclosures **do** "open the door" to understanding the nature of the tax issue and **do** ensure that the IRS has sufficient information to know how to further develop the issue in their audit. There are at least three variables that will enter into this disclosure statement:

> Variable 1: If the taxpayer does not provide sufficient information for the IRS to understand what further information requests are needed in order to develop the issue in audit, then it is foreseeable that the IRS audit practice at the time of the audit of the taxpayer's 2010 tax return will provide the IRS examination team with authority to request the taxpayer's FIN 48 tax accrual workpapers whenever the concise description is insufficient to allow the IRS to pursue the issue. To avoid this risk, taxpayers need to give the IRS a sufficiently adequate disclosure to allow the IRS to understand the nature of the issue.
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> Variable 2: If the "concise description" allows the IRS to quickly conclude that the tax position raises a coordinated issue, then development of the issue may be controlled by functional experts outside of the local examination team. The IRS has indicated that the Large Business and International Division (LB&I) is establishing a centralized processing team to collect and review filed Schedules UTP to aid in the audit selection and to aid in coordination of similar issues.[72] Taxpayers have expressed

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[71] *See* Treas. Reg. §1.6011-4(b) (setting forth a list of transactions that are of particular interest to the IRS and that therefore require specific disclosure); *see also* Actions Relating to Court Decisions, 1999-2 C.B. 314 (August 30, 1999) (explaining the IRS policy for its "action on decisions" [i.e., whether to acquiescence or non-acquiescence to decided court cases]).

[72] *See* Amy Elliott, *Pretty Good Guidance Should Be Good Enough for IRS, Official Says*, Tax Notes Today (Tax Analysts) Doc. 2010-25851 (Dec. 6, 2010), *available at* LEXIS 2010 TNT 233-4.

> concern that grouping the individual taxpayer's issue with a host of other similarly situated taxpayers will take authority for case management out of the local examination team and make it harder for any of these taxpayers to have their individual case developed and evaluated on its particular facts and merits.[73]
>
> Variable 3: If the "concise description" substantively evaluates the position, then this could create a party admission or subject matter waiver over the particular issue.

What is not a variable, at least in this author's mind, is the thought of crafting a final Schedule UTP disclosure statement that would avoid "opening the door" to the potential tax exposure item. In the author's view, an attempt to pursue that objective would cause the disclosure to be inadequate such that the IRS would then pursue production of the taxpayer's FIN 48 workpapers. The logical consequence of this scenario would then be that the exposure item will be fully understood anyway and the taxpayer may be in a worse position if the FIN 48 workpapers contain opinion statements that could be viewed as party admissions. Thus, in any scenario, this author believes that taxpayers will come to expect that the IRS will obtain the taxpayer's list of material uncertain tax positions and that the least risky approach for providing this information to the IRS is to fully completing Schedule UTP. The days of "hiding the ball" are gone, and the best tax practice will be for the taxpayer to expect that all information about a tax position that is taken on a tax return will be available for inspection and reviewed by the IRS. The implications for tax practice are real and significant. Taxpayers more than ever should take tax positions with the expectation that they will be fully disclosed to the IRS and will be fully understood by the government. Thus, tax planning should be done with the assumption of transparency. Tax planning that cannot survive the rigors of this transparency should be avoided. Business practices that create significant tax risk need to be revisited and modified.

IV. HOW WHISTLE BLOWER AWARDS IMPACTS THE ANALYSIS

The whistleblower provisions of §7623 significantly alter the equation with respect to a company's expectation of confidentiality of its internal documents. The practical reality is that §7623 creates a significant motivation for companies to deal with uncertain tax positions in a fully transparent manner with the IRS.

In 2006, in an effort to reduce the "tax gap," Congress increased the potential amount for whistleblower awards to 30% of any tax recovery when a whistleblower provides significant information that leads to the collection of a tax underpayment.[74] If the information provided by a whistleblower contributed to the collection of an underpayment but was determined to be a non-significant factor, then the whistleblower would be entitled to a reduced award. Congress has called on the IRS to accelerate its use of this whistle-blower program and to commence paying bounties to whistle-blowers in order to spur further whistle-blower filings.[75]

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[73] *Id.*

[74] *See* 26 U.S.C. §7623(a) (2002).

[75] *See* Sen. Chuck Grassley, *Proposed Regs Are 'Good News' for Whistleblowers, Grassley Says*, Tax Notes Today (Tax Analysts) Doc. 2011-1020 (Jan. 14, 2011), *available at* LEXIS 2011 TNT 11-106.

Plaintiff firms, through advertisements in various tax publications and via their websites, have urged individuals to contact them for assistance in filing whistleblower claims based on the information contained in their employer's FIN 48 tax accrual workpapers.[76] In fact, one plaintiff's firm has asserted that it has filed a $4.4 billion whistleblower submission and that its client may be entitled to a whistleblower award for 30% of that amount.[77]

The ability of employees to use a company's FIN 48 tax accrual workpapers as a basis for submitting whistleblower claims raises several unresolved issues. First, should the IRS accept this information? It appears that the IRS is receptive to whistleblower claims filed on the basis of a company's FIN 48 tax accrual workpapers.[78] In Chief Counsel Memorandum CC-2010-004, the IRS Chief Counsel laid out a process for follow-up interviews with whistleblowers. The IRS stated that "a long-standing line of cases support the ability of the government to use information received from a private party, even if the private party obtained the information in an illicit or illegal manner, as long as the government is a passive recipient of the information." The memorandum goes on to state that follow-up consultations will not cause the IRS to jeopardize its status as a "passive recipient" for this purpose. At some level, it seems inconsistent to this author for the IRS not to request a taxpayer's FIN 48 tax accrual workpapers as a matter of administrative restraint but then at the same time to provide whistleblower awards to informants for providing their employer's FIN 48 tax accrual workpapers to the government. If the FIN 48 tax accrual workpapers are helpful and useful to the IRS, then the IRS should make a regular practice of obtaining this information itself through the IRS audit process and should not provide whistle-blower awards to informants for FIN 48 information except when that information is not made readily available to the government by the taxpayer.

Another important question is whether and to what extent a company's affirmative disclosure of an uncertain tax position on final Schedule UTP will impact the ability for a whistleblower to claim an award based on the whistleblower's production of the company's FIN 48 tax accrual workpapers.[79] If the company disclosed its uncertain tax position on final Schedule UTP, an argument can be made that the production of the company's FIN 48 tax accrual workpapers under the whistle-blower program does not provide any meaningful new in-

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[76] *See Law Firm Analyzes Unrecognized Tax Benefit Reserves Among Fortune 500*, Tax Notes Today (Tax Analysts) Doc. 2010-19374 (Sept. 2, 2010), *available at* LEXIS 2010 TNT 170-36 ("The details in the tax accrual work papers often make for valuable tax whistleblower submissions."); *Welcome to The Ferraro Law Firm—Tax Whistleblower Attorneys*, THE FERRARO LAW FIRM, www.tax-whistleblower.com (last visited Apr. 7, 2011).

[77] *See* Ferraro Law Firm, *Ferraro Law Firm Files $4.4 Billion Whistle-Blower Submission with IRS*, Tax Notes Today (Tax Analysts) Doc. 2008-13182 (June 13, 2008), *available at* LEXIS 2008 TNT 116-61; *see also* Press Release, Ferraro Law Firm, Fiscal Year 2009 Annual Report to Congress Signals Opportunities for New Tax Whistleblowers 1 (December 13, 2010), *available at* http://taxprof.typepad.com/files/ferraro-press-release.pdf ("[T]here is approximately $200 billion of uncertain tax positions for [the Fortune 500 companies alone]. 'Those who come forward now with information regarding significant tax underpayments are more likely to receive awards than those who wait because awards are given to the informant who first provides the information to the IRS,' . . . .").

[78] *See* Jeremiah Coder, *Chief Counsel Approves More Interaction With Whistleblowers*, Tax Notes Today (Tax Analysts) Doc. 2010-3872 (Feb. 24, 2010), *available at* LEXIS 2010 TNT 36- 3.

[79] *See* Jeremiah Coder, *Practitioners Disagree Over Effect of UTP Reporting on Whistleblower Claims*, Tax Doc. 2010-19323, 2010 TNT 170-1 (September 2, 2010).

formation to the government. However, the taxpayer's FIN 48 tax accrual workpapers may provide insights that aid the IRS in "detecting and bringing to trial persons violating the internal revenue laws" and thus may fulfill the literal requirements for a whistleblower award under §7623(a). Thus, it would be helpful if the IRS would provide guidance in this situation.

Nevertheless, regardless of the course of future IRS guidance on these questions, this discussion reinforces the need for taxpayers to fully and adequately complete Schedule UTP. The company's tax officer does not want to have a situation where a company employee has filed a whistle-blower claim that asserts the company failed to adequately disclose its tax obligations.[80] Recent press reports speculate that significant whistle-blower awards may soon be awarded, and there are firms that are actively soliciting clients to submit claims.[81] In today's world, too many people touch the company's FIN 48 tax accrual workpapers for a tax officer to believe that such information will remain confidential. A company's tax officer will want to avoid a scenario where a whistle-blower files a claim that a company has underreported its taxes and the basis for this whistle-blower claim was not adequately disclosed on Schedule UTP. If such a scenario were to arise, it is foreseeable that the tax officer will find it difficult to explain to the company's general counsel and to the company's board of directors why the company failed to act transparently with the IRS and created whistle-blower exposures. The corporate governance reforms adopted by SOX will make this potential scenario untenable for any reasonable tax officer, and so again this author concludes that the only practical course of conduct in this age of transparency is to fully and accurately disclose a company's uncertain tax positions in a transparent manner on Schedule UTP.

V. POTENTIAL FUTURE REFORMS ARE ON THE HORIZON

The pace of change is accelerating, and in these changing times it is advisable to have a prediction of where the law is headed in order to plan accordingly. The following section sets forth three areas where further change is likely to occur, and in combination these further predictable reforms augur for taxpayers to re-examine their tax planning and tax compliance processes to ensure that they will be able to withstand the added transparency that is likely to exist at the time these processes are reviewed by the government.

A. Reform of Tax Reporting Standards

Taxpayers who now have an obligation to complete Schedule UTP are likely to conclude that they should minimize the instances where the taxpayer claims unsustainable tax positions that require a reserve on the company's financial statements. To achieve this end, tax

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[80] For an indication of how uncomfortable such a situation can be, *see* David Cay Johnston, *Can Loopholes Blow the Whistle on Whistleblowers,* Tax Doc. 2010-25562, 2010 TNT 233-11 (December 6, 2010). *See also* Kelley Semrau, *"SC Johnson Official Refutes Johnston's Recent Column,*Tax Doc. 2010-26204, 2010 TNT 238-14 (December 13, 2010).

[81] Jeremiah Coder, *IRS Whistleblower Office Reports High Submissions, Omits Controversial Issues*, Tax Doc. 2010-26590, 2010 TNT 240-4 (December 15, 2010)*; see also* Coder, *"IRS Pays First Enhanced Whistleblower Award,"* 2011 TNT 69-4, Doc. 2011-7587 (April 11, 2011) (announcing a whistleblower award of $4.5 million to an in-house accountant for information about the accountant's employer).

functions should immediately discuss with their business units how to minimize the areas of tax risk associated with their business model.

In a broader sense, Schedule UTP is a natural outgrowth of the apparent inability of the IRS to collect through the audit process the full amount of taxes that taxpayers believe in their own self-assessment should have been collected. A common practice in today's environment is for a public company to assert to the IRS that it owes a lower tax liability when it files its tax return but then to assert that it has a higher, but as yet unpaid, tax liability when it files its financial statements with the SEC. Thus, different government agencies are being told different things. When a company swears that the correct amount of tax is one amount on its tax return but then simultaneously swears on its financial statements that its tax obligation is something else, the result is that the company is making inconsistent assertions. Before FIN 48, the outright inconsistency could have been explained away because prior GAAP guidance allowed taxpayers to keep more nebulous and more generalized tax reserves. FIN 48 takes away that argument because a FIN 48 reserve can only be established after a company positively identifies its unsustainable tax positions through a separate issue-by-issue analysis.

This raises an obvious question: if a company believes that its tax liability is higher than the amount shown on its tax return due to unsustainable tax positions taken in the tax return, then why can the company knowingly file its tax return with such unsustainable tax positions in the return without risk of penalty? This state of affairs leads to high public cynicism about noncompliance.[82] Public cynicism is harmful to the country and creates a perception that the existing U.S. tax burden is not being fairly borne by sophisticated corporate taxpayers.[83] The logical conclusion to this line of inquiry is that the nation's tax laws should no longer allow a taxpayer to take a tax return position that the taxpayer has positively concluded is unsustainable in the company's own view.[84]

In section 563 of the Affordable Health Care for America Act, Congress had proposed to increase the standards for tax reporting for certain large publicly-traded corporations to require those taxpayers to take tax positions only where they reasonably believe that the tax treatment is more likely than not the proper treatment.[85] Congress did not enact this proposal. Given the systemic problems created by the tax gap and the public's desire for greater voluntary tax compliance, this author has stated elsewhere that the law should (and likely will) be changed so that taxpayers, tax return preparers, and tax advisors could only advocate an uncertain tax position without a risk of an understatement penalty or sanction if they reasonably be-

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[82] Lee Sheppard, *Tax Schemes are Proliferating, Official Tells NYU Conference,* 2009 TAX NOTES TODAY 200-1 Oct.20, 2009 ("Never in history has the American public been more aware of noncompliance."); I.R.S. News Release 2008-137 (December 8, 2008) (stating that 80 percent of respondents believe that it is very important that IRS ensure that large corporations are reporting and paying their taxes honestly).

[83] I.R.S. News Release 2009-95 (October 19, 2009) ("In today's business climate, the general public has little tolerance for overly aggressive tax planning that can be viewed as corporations playing tax games.").

[84] *See* Bret Wells, *Voluntary Compliance: This Return Might Be Correct, But Probably Isn't,* 29 Virginia Tax Rev. 645, 668-72 (2010) (setting forth a recommendation for how current law should be changed to address this concern).

[85] *See* Affordable Health Care for America Act, H.R. 3962, 111th Cong. §563 (2009).

lieved that the uncertain tax position is likely to be sustained.[86]

The added transparency required by the SOX section 302 and section 404 along with FIN 48's added disclosure requirements has brought so much transparency that it is foreseeable that Congress would seek to force financial statement and tax return reporting conformity by requiring companies to only take tax positions on their tax return that are sustainable in the amounts believed to be sustainable by them. Given this likely legislative response, taxpayers should take corrective actions now to minimize and eliminate their reliance on tax positions that are unsustainable in the taxpayer's own view. Where reducing these tax risks require changes in the manner in which business is conducted, the tax functions should immediately re-engage with their business units to make the necessary corrective changes.

B. Further Changes Forthcoming to the Policy of Restraint

In 1981, the IRS announced a "policy of restraint," stating that it would generally not seek production of a taxpayer's tax accrual workpapers.[87] This "policy of restraint" continued until 2002 when the IRS abruptly modified its longstanding "policy of restraint."[88] In Announcement 2002-63, 2002-2 C.B. 72, the IRS stated that it would request a taxpayer's tax accrual workpapers if a taxpayer failed to disclose its participation in a listed transaction. In 2003, the IRS further modified and clarified its revised policy of restraint, stating that it would request all tax accrual workpapers if the taxpayer failed to disclose listed transactions on returns filed after July 1, 2002, if the taxpayer claimed benefits from multiple listed transactions on returns filed after July 1, 2001, or if other financial irregularities existed.[89] In 2004, the IRS clarified the distinction between "tax accrual workpapers" (which are subject to the IRS's policy of restraint) and "tax reconciliation workpapers" (which can be routinely requested).[90]

In announcing its development of this Schedule UTP for large taxpayers, the IRS asserted that the taxpayer's FIN 48 information is highly relevant to understanding the taxpayer's

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[86] *See* Bret Wells, *Voluntary Compliance: This Return Might Be Correct, But Probably Isn't*, 29 Virginia Tax Rev. 645 (2010).

[87] IR-News Rel. 81-49 (original statement by Commissioner Egger announcing the policy to the California CPA Tax Section*); see also* Announcement 84-46, 1984-18 I.R.B. 18 (announcing that in response to the Arthur Young decision, the Service would not alter its current procedures for requesting tax accrual workpapers relating to the evaluation of a corporation's reserves for contingent tax liabilities); *see also* Ad Hoc Subcomm. of the Comm.on Law & Accounting, A Qualified Privilege for Tax Accrual Workpapers, 39 BUS. LAW. 247 (1983). Announcement 84-46, 1984-18 IRB 18 (announcing that notwithstanding the IRS victory in *Arthur Young* the IRS would still continue its "policy of restraint" with respect to tax accrual workpapers relating to the taxpayer's reserves for contingent tax liabilities).

[88] Announcement 2002-63, 2002-2 C.B. 72. The current formulation of the IRS policy of restraint can be found in I.R.M. 4.10.20 and Announcement 2010-76, 2010-41 IRB 1; *see also* I.R.S. Chief Couns. Mem. AM2007-0012 (Mar. 22, 2007)*; see also* IRS Large Business & International, Frequently Asked Questions on Schedule UTP, Q&A #5 & #6, available at *http://www.irs.gov/businesses/article/0,,id=237538,00.html, reprinted at* 2011 TNT 57-1, Doc. 2011-6154 (March 3, 2011) (stating that policy of restraint applies to IRS Appellate Officers and generally is followed by IRS counsel but that further guidance on the impact of the policy of restraint on IRS counsel will be the subject of further guidance).

[89] *See* I.R.S. Chief Couns. Notice CC-2003-012 (April 9, 2003); *see also* See IRM 4.10.20.

[90] *See* I.R.S. Chief Couns. Notice CC-2004-010 (January 22, 2004).

tax positions and assessing how those positions affect the taxpayer's tax liability.[91] The IRS also stated that a taxpayer's FIN 48 information would aid the government in focusing its examination resources on returns that contain specific uncertain tax positions that are of particular interest or of sufficient magnitude to warrant further inquiry as well as allowing examination teams to identify all of the issues underlying the tax returns more quickly and efficiently.[92] After making these statements about the probative value of a taxpayer's FIN 48 workpapers, the IRS reiterated that it does not intend to request the taxpayer's FIN 48 workpapers and will continue its existing policy of restraint during the course of examinations.[93] However, the IRS indicated that it would continue to review its existing policy of restraint and may consider additional modifications to ensure it obtains complete and accurate information regarding a taxpayer's uncertain tax positions on a timely basis.[94]

As indicated in the earlier discussion, if the taxpayer fails to adequately disclose its uncertain tax positions on final Schedule UTP, one would expect that the IRS would modify its policy of restraint as an appropriate response to deal with taxpayer noncompliance with respect to adequately completing final Schedule UTP. In this author's view, this change is the minimum change that could be expected. In fact, some officials in the IRS and Treasury have raised the question of whether the IRS should entirely eliminate its policy of restraint.[95]

Given that it is foreseeable that the IRS will continue to modify its policy of restraint, taxpayers should now ensure that its existing tax planning and tax compliance processes are done with the assumption that all tax positions and all tax opinions are likely to be reviewed by the IRS and that the tax positions will be fully disclosed and fully understood on audit. In today's age of transparency, it is no longer reasonable for a taxpayer to believe that its written documentation on tax positions will be confidential.

C. Privilege Implications

One would expect that the issue of privilege with respect to FIN 48 tax accrual workpapers would likely be an area of significant continuing controversy between taxpayers and IRS examination agents. However, even though controversy is likely to continue in this area, taxpayers have sufficient reason to believe that it is not going to be successful in forestalling the IRS's access to the company's FIN 48 tax accrual workpapers or documentation related to the uncertain tax positions that appear on Schedule UTP. Accordingly, taxpayer's should engage in current tax planning under the assumption that no privilege will exist with respect to

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[91] I.R.S. Announcement 2010-9, 2010-7 I.R.B. 408; *see also* I.R.S. Announcement 2010-30, 2010-19 I.R.B. 668.

[92] *Id.*

[93] *Id.*

[94] *Id.*

[95] Stephen Joyce, *IRS Mulling Change to 'Policy of Restraint' Concerning Accrual Papers, IRS Official Says*, DAILY TAX REP. (Wash., D.C.), Feb. 9, 2007, at G-1; Stephen Joyce, *IRS Not Amending 'Policy of Restraint' on Taxpayer Tax Accrual Workpapers*, DAILY TAX REP. (Wash., D.C.), Oct. 12, 2007, at G-6; Stephen Joyce, *Nolan Discusses Efforts to Create Efficiencies While Providing Taxpayers Certainty Sooner*, DAILY TAX REP. (Wash., D.C.), Apr. 13, 2007, at G-2; Dustin Stamper, *No Plans to Change Restraint Policy for Workpapers, Stiff Says*, 2007 TAX NOTES TODAY 205-1 (Oct. 23, 2007).

the tax positions that are taken on a tax return and that are incorporated into a company's FIN 48 tax accrual workpapers. A review of the relevant case law and the basis for this legal conclusion is set forth below.

As an initial matter, it is clear that FIN 48 workpapers are relevant business records that would be of potential interest to the IRS.[96] In *Powell v. U.S.*, the Supreme Court held that the IRS could enforce a summons to obtain relevant business records as long as (i) the IRS investigation has a legitimate purpose, (ii) the IRS inquiry may be relevant to its legitimate investigation, (iii) the information sought is not already within the IRS's possession, and (iv) the administrative steps required to issue a summons have been followed.[97] The Supreme Court has analogized the IRS's investigatory power to that of a grand jury.[98] The summons power afforded the IRS under section 7602 reflects a congressional policy in favor of disclosure of all information relevant to a legitimate IRS inquiry and courts have been reluctant to restrict the IRS's power to summons information absent unambiguous directions from Congress.[99] The Supreme Court articulated the broad investigatory authority granted to the IRS in the following statement:

> We begin examination of these sections against the familiar background that our tax structure is based on a system of self-reporting. There is legal compulsion to be sure, but basically the Government depends upon the good faith and integrity of each potential taxpayer to disclose honestly all information relevant to tax liability. Nonetheless, it would be naive to ignore the reality that some persons attempt to outwit the system, and tax evaders are not readily identifiable. Thus, §7601 gives the Internal Revenue Service a broad mandate to investigate and audit "persons who may be liable" for taxes and §7602 provides the power to "examine any books, papers, records or other data which may be relevant . . . and to summon . . . any person having possession . . . of books of account . . . relevant or material to such inquiry."[100]

Although FIN 48 tax accrual workpapers are highly relevant business records, the IRS has a policy of not asking for these documents at the IRS examination level but has left the door open for the government to request this information at other procedural points in a tax dispute.[101] As a result, the question then becomes whether FIN 48 tax accrual workpapers are protected from potential discovery, and these issues are discussed more fully in the following two sections.

i. Attorney Client Privilege

If the FIN 48 tax accrual workpapers included tax advice from an attorney or from a

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[96] I.R.S. Announcement 2010-9, 2010-7 I.R.B. 408.

[97] *See* Powell v. U.S., 379 U.S. 48, 57-58 (1964).

[98] *See* Morton Salt v. United States, 338 U.S. 632, 642 (1950).

[99] *See* United States v. Bisceglia, 420 U.S. 141, 145-46 (1975).

[100] *Id.*

[101] Announcement 2010-76, 2010-41 I.R.B. 432; *Requirement of a Statement Disclosing Uncertain Tax Positions*, 75 Fed. Reg. 78610-01 (Dec. 15, 2010)(to be cited at 26 C.F.R. pt. 1).

federally authorized tax practitioner, then the tax advice may be entitled to privilege under both the common law attorney-client privilege and/or under the statutory privilege set forth in 26 U.S.C. §7525 (a) (2006).[102] However, the attorney-client privilege (and the statutory privilege provided to federally authorized tax practitioners)[103] can be waived if the tax advice is disclosed to a third party.[104] In particular, the company's disclosure of its legal opinions to its external financial auditors has historically been understood to constitute a waiver of the attorney-client privilege and thus would represent a waiver of the statutory privilege afforded by §7525 as well.[105] Given that the external auditors now routinely require a full disclose of all tax opinions and tax advice received by a company to substantiate their FIN 48 analysis,[106] the attorney-client privilege that may have existed as a prima facie matter is **always waived** as a practical matter.[107] Thus, neither the attorney-client privilege nor the statutory privilege set forth in section 7525(a) would apply after this information has been shared with external auditors.

ii. Attorney Work-Product Protection

The core of the attorney work product doctrine relates to opinion work product, and this protection prevents discovery of the mental processes of the attorney so that the attorney

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[102] *See* Upjohn Co. v. United States, 449 U.S. 383, 386 (1981) (refusing to enforce IRS summons because documents sought contained communications protected by the attorney-client privilege and attorney work-product doctrine). For the statutory privilege that applies to communications between a tax practitioner and her client, *see* 26 U.S.C. § 7525(a) (2006).

[103] Non-attorney federally authorized tax practitioners includes certified public accountants and authorized enrolled agents. *See* §10.03, Tres. Dept. Circular No. 230 (Rev. 4-2008).

[104] *See* United States v. Davis, 636 F.2d 1028, 1043 n.18 (5th Cir. 1981).

[105] *See* United States v. El Paso Corp., 682 F.2d 530, 540-41 (5th Cir. 1982); First Fed. Sav. Bank of Hegewisch v. United States, 55 Fed. Cl. 263, 268–69 (Fed. Cl. 2003) (finding waiver of attorney-client privilege when board minutes containing confidential communications between board members and outside counsel were disclosed to outside auditors who were auditing company's financial statements).

[106] Robert H. Aland, et al., *The Corporate Tax Director: Responsibilities in the New Era of Increased Corporate Accountability*, 83 Taxes 91 (Mar. 2005). The American Institute of Certified Public Accountants (the "AICPA") has made it clear that a company desiring an unqualified financial audit opinion cannot refuse to disclose to its outside auditor any tax advice the company may have received from its attorneys about material financial statement items, even if such disclosure waives privilege. *See* AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, CODIFICATION OF STATEMENTS ON AUDITING STANDARDS, AU § 9326, P 2.22 ("If the client's support for the tax accrual or matters affecting it, including tax contingencies, is based upon an opinion issued by an outside adviser with respect to a potentially material matter, the auditor should obtain access to the opinion, notwithstanding potential concerns regarding attorney-client or other forms of privilege."). Furthermore, officials with the SEC have stated on several different occasions that the company needs to provide its written documentation that demonstrates its issue-by-issue evaluation under FIN 48 to the company's external auditors before the external auditor can be in a position to opine on the company's internal controls as required by SOX. *See* Jane D. Poulin, Remarks Before the 2004 AICPA National Conference on SEC and PCAOB Developments, Dec. 6, 2004; Neil D. Traubenberg, Chester Abell, Jr., Paul A. Beswick & Brett E. Cohen, *Session 6: Making the "Final Judgments" on Implementing the New Standard on Accounting for Uncertainty in Income Taxes*, 85 Taxes 95, 96 (June 2007) at 98 (reporting comment of Joel V. Williamson, partner in the Chicago office of the law firm of Mayer, Brown, Rowe & Maw and head of the firm's Tax Controversy and Transfer Pricing Department).

[107] El Paso Co., 682 F.2d at 540-541; First Fed. Sav. Bank of Hegewisch, 55 Fed. Cl. at 268-69.

can analyze and prepare a client's case for trial.[108] In 1970, the attorney work product doctrine, originally enunciated in *Hickman v. Taylor,* 329 U.S. 495 (1947), was partially codified with respect to materials and tangible things prepared in anticipation of litigation or for trial under Fed. R. Civ. P. 26(b)(3). However, the notes of the Advisory Committee on the 1970 amendments provided an important limitation on the work product privilege, namely that it did not extend to "[m]aterials assembled in the ordinary course of business, or pursuant to public requirements unrelated to litigation, or for other non-litigation purposes are not under the qualified immunity provided by this subdivision." Thus, the attorney work product doctrine does not apply to ordinary business records that would have been created in the ordinary course of business, regardless of the prospect of future litigation.[109] As will be discussed further below, the better view is that FIN 48 tax accrual workpapers are business records that serve a regulatory requirement. As such, any attorney opinions that are incorporated into these documents take those opinion materials out of the attorney work product protection.

The focal point for the question about whether the attorney work product doctrine protects attorney opinions that are incorporated into the taxpayer's FIN 48 tax accrual workpapers begins with the Supreme Court's decision in *U.S. v. Arthur Young & Co*.[110] In the *Arthur Young* case, the IRS sought discovery of Arthur Young's files related to its audit of Amerada Hess as part of a criminal tax investigation of Amerada Hess. The files held by Arthur Young included Amerada Hess' tax accrual workpapers. These workpapers included documents and memoranda relating to Arthur Young's evaluation of Amerada Hess' reserves for contingent tax liabilities and included interview notes of Amerada Hess personnel. Amerada Hess instructed Arthur Young not to comply with the IRS summons that sought discovery of these sensitive tax documents; therefore, litigation to compel production ensued. The district court held that the tax accrual workpapers were both relevant and discoverable, thereby ordering Arthur Young to produce the documents.[111] The Second Circuit Court of Appeals reversed the district court,[112] and in doing so, attempted to fashion an accountant work-product doctrine patterned after the attorney work-product doctrine that was announced in *Hickman v. Taylor.*[113] The Second Circuit's attempt to create a brand new accountant work product privilege was motivated by a concern that production of tax accrual workpapers gave the IRS a roadmap that would be an unfair adversarial advantage. The Second Circuit's attempt was also motivated by a concern that regular production of these documents would cause taxpayers to withhold this information from their external auditors, thus jeopardizing the quality of the financial audit and the reliability of the company's public filings.

It was in this context that the Supreme Court granted certiorari and reversed the Se-

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[108] *See* United States v. ChevronTexaco Corp., 241 F. Supp. 2d 1065, 1090 (N.D. Cal. 2002).

[109] *See* Shapiro v. United States, 335 U.S. 1, 55-56 (1948) (to determine whether records are required public records, a court must consider "their custody, their subject matter, and the use sought to be made of them); *see also* United States v. Adlman, 134 F.3d 1194, 1202 (2d Cir. 1998).

[110] *See* United States v. Arthur Young & Co., 465 U.S. 805, 807 (1984).

[111] United States v. Arthur Young & Co., 496 F. Supp. 1152, 1160 (S.D.N.Y. 1980), *aff'd in part, rev'd in part*, 677 F.2d 211 (2d Cir. 1982).

[112] United States v. Arthur Young & Co., 677 F.2d 211, 214 (2d Cir. 1982), *aff'd in part, rev'd in part*, 465 U.S. 805 (1984).

[113] United States v. Arthur Young & Co., 465 U.S. at 810.

cond Circuit Court of Appeals' decision.[114] The Supreme Court rejected the Second Circuit's expansion of the attorney work-product doctrine to accountant's tax accrual workpapers. The Supreme Court then dismantled the Second Circuit's policy concerns that motivated it to articulate a possible expansion of the work product doctrine to encompass accounting records. The Supreme Court rejected out-of-hand the idea that the integrity of the financial audit would be called into question if tax accrual workpapers were regularly disclosed to the IRS.[115] The Supreme Court then asserted that the auditor's analysis of a taxpayer's financial statement tax reserves represented ordinary business records. The Supreme Court concluded its opinion by stating that Congress could provide additional protections from disclosure, but the Court would leave it to Congress to craft any additional protection.[116] Thus, the Supreme Court did not restrict the scope of the IRS's right to inspect relevant business records including tax accrual workpapers and did not expand the scope of any existing privilege.

Subsequent to the *Arthur Young* case, the First Circuit in *Textron*[117] and the Fifth Circuit in *El Paso*[118] have concluded that tax accrual workpapers represent ordinary business records that are not entitled to attorney work product protection, even if these documents contain opinions from counsel about a company's uncertain tax positions. These cases stand for the proposition that FIN 48 tax accrual workpapers represent normal business records. Regardless of whether litigation is expected, a public company must create written documentation that sets forth its analysis of why it is entitled (or is not entitled) to claim a financial statement benefit for all sorts of financial matters, including tax matters. If FIN 48 tax accrual workpapers were protected from discovery when prepared by an attorney, then attorneys would be given greater deference for creating ordinary business records than accountants. It is one thing to provide a privilege for attorney's who are preparing for trial. It is another thing to extend that privilege to cover an attorney who is creating ordinary business records that serve an accounting and regulatory compliance function.[119] Thus, consistent with the notes of the Advisory Committee

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[114] *Id.* at 821.

[115] *Id.* at 819-20.

[116] *Id. at 821;* Congress eventually did respond to the *Arthur Young* decision by providing a narrowly tailored statutory privilege that is set forth in §7525. It is important to note that Congress declined to enact an accountant work product privilege for tax accrual workpapers. *See* United States v. KPMG LLP, 316 F. Supp. 2d 30 (D.D.C. 2004). Instead, Congress decided to give the same privilege protection to tax advice given by a federally authorized tax practitioner to a client that exists under the attorney-client privilege chose to not expand the scope of the existing attorney-client privilege beyond its historical understanding. Although §7525 gives the same privilege protection to tax advice given by a federally authorized tax practitioner as exists under the attorney-client privilege, the statutory privilege afforded by § 7525(a) is narrower in that § 7525(b) denies the right to this statutory privilege for tax advice that is given with respect to a tax shelter.

[117] *See* United States v. Textron Inc. & Subsidiaries, 577 F.3d 21, 31-32 (1st Cir. 2009), *vacating & remanding* United States v. Textron Inc & Subsidiaries, 507 F. Supp. 2d 138 (DRI 2007).

[118] United States v. El Paso Corp., 682 F.2d 530, 543-44 (5thCir. 1982) (similarly holding that tax accrual workpapers are not entitled to work product protection). *But see* United States v. Deloitte LLP, 610 F.3d 129 (D.C. Cir. 2010).

[119] For a scholarly and detailed analysis of the work product doctrine that is consistent with the author's view, *see* Ventry, *A Primer on Tax Work Product for Federal Courts,* 123 Tax Notes 875, 2009 TNT 94-8 (May 18, 2009); Ventry, *Protecting Abusive Tax Avoidance*, 120 Tax Notes 857, 2008 TNT 171-26 (September 1, 2008); Pease-Wingenter, *The Application of the Attorney-Client Privilege to Tax Accrual Workpapers: The Real Legacy of United*

on the 1970 amendments to Fed. R. Civ. P. 26(b)(3), these cases hold that that attorney work product protection does not protect ordinary business records that are created to meet accounting or regulatory requirements. Again, as the Supreme Court stated in *Arthur Young*, Congress can restrict the liberal access rights that it has given the IRS if it so desires. Thus far, Congress has not expressed any desire to protect FIN 48 workpapers from discovery.

However, the DC Circuit in *United States v. Deloitte LLP* has held that memoranda prepared by Deloitte as part of its financial audit of Dow Chemical Company were entitled to the attorney work-product protection because the memoranda included interview statements made by Dow's legal counsel about potential tax litigation exposures. The DC Circuit was convinced that the identity of the person that created the memoranda (namely, an accountant) is not critical. Instead, according to the DC Circuit, what was critical was whether the memoranda contained the mental impressions and legal opinions of counsel who was anticipating litigation. The DC Circuit went on to state that the Deloitte memoranda represented dual use documents that were created because of the risk of litigation and would not have been created if litigation had not been contemplated. Based on this reasoning, the DC Circuit held that the attorney work product protection could apply to tax accrual workpapers to the extent that these documents contained opinions of counsel. This case openly disagrees with the reasoning in *Textron* and *El Paso,* and the court simply rejects those cases as wrongly decided. Finally, the DC Circuit did not discuss or reconcile its opinion with the limitation to the attorney work product doctrine set forth in the notes to the Advisory Committee on the 1970 amendments to the Fed. R. Civ. P. 26(b)(3) with respect to opinion documents that are used to serve a regulatory compliance purpose.

Prior cases have held that tax planning memoranda may be entitled to attorney work product protection when prepared by attorneys, but those cases explicitly limited their holding to tax planning materials that were not used for a routine regulatory compliance process or for a tax return preparation purpose.[120] In fact, the courts in *Adlman* and *Roxworthy* specifically cited favorably the notes to the Advisory Committee on the 1970 amendments to Fed. R. Civ. P. 26(b)(3) and both state in the course of their opinions that the attorney work product protection would not apply to situations where an attorney's opinion documents are created for a regulatory compliance process.[121] The attorney opinion documents in the *Deloitte* case did get incorporated into routine regulatory compliance documents (i.e., into the company's FIN 48 tax accrual workpapers) and therefore do seem to run afoul of the limitation to the attorney work product protection discussed in the notes to the Advisory Committee on the 1970 amendments to the Fed. R. Civ. P. 26(b)(3). Thus, although *Adlman* and *Roxworthy* adopted a less stringent standard of review for determining whether an attorney opinion document was created "in anticipation of litigation,"[122] the decisions in *Adlman* and *Roxworthy* are consistent

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States v. Textron, 8 Hous. Bus. & Tax L.J. 337 (2008).

[120] *See e.g.,* United States v. Adlman, 134 F.3d 1194 (2d Cir. 1998) (memorandum given to in-house legal counsel that analyzed tax risk associated with a proposed merger was entitled to attorney work product protection); United States v. Roxworthy, 457 F.3d 590 (6th Cir. 2006) (memoranda was entitled to attorney work product protection even though the legal advice sought aided in the business decision about whether to proceed with a captive insurance company).

[121] United States v. Adlman, 134 F.3d at 1202; United States v. Roxworthy, 457 F.3d at 593-4.

[122] Nine circuits have generally provided attorney work product protection when a document was prepared "be-

with the decisions in *El Paso* and *Textron* in stating that attorney opinion documents created for a regulatory compliance purpose are not entitled to protection under the attorney work product doctrine. Furthermore, the restrictive language used in *Adlman* and *Roxworthy* contradicts the DC Circuit's holding in *Deloitte* that attorney opinion documents are entitled to work product protection when they are incorporated into regulatory compliance documents.[123] Thus, given prior precedent and the weight of existing authorities that have addressed tax opinion materials, taxpayers and their advisors should view the decision in the *Deloitte* case as a distinct minority view and place limited reliance on that decision.

Furthermore, an interesting question to now consider is whether the obligation to complete final Schedule UTP will cause a taxpayer's expectation of confidentiality to further erode. In this regard, the completion of final Schedule UTP represents a "tax return preparation process." To this point, a significant line of case law has held that the attorney work product protection does not extend to documents that are part of the tax return preparation process because that process represents accounting work, even when it is prepared by an attorney.[124] For example, in *Frederick*,[125] documents were submitted to the attorney/accountant that served a dual purpose. One purpose was to allow the advisor to prepare for possible litigation. Another purpose was to allow the tax advisor to know how to report the transaction on the tax return. The court in *Frederick* held that dual-purpose documents were not entitled to

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cause of" the prospect of litigation. *See, e.g.*, Maine v. United States, 298 F.3d 60 (1st Cir. 2002). *In Re* Sealed Case, 146 F.3d 881, 884 (D.C. Cir. 1998); United States v. Adlman, 134 F.3d 1194, 1202-03 (2d Cir. 1998); Martin v. Bally's Park Place Hotel & Casino, 983 F.2d 1252, 1260 (3d Cir. 1993); National Union Fire Ins. Co. v. Murray Sheet Metal Co., 967 F.2d 980, 984 (4th Cir. 1992); United States v. Roxworthy, 457 F.3d 590, 593 (6th Cir. 2006); Binks Mfg. Co. v. National Presto Indus., Inc., 709 F.2d 1109, 1118-19 (7th Cir. 1983); Simon v. G.D. Searle & Co., 816 F.2d 397, 401 (8th Cir.), *cert. denied*, 484 U.S. 917 (1987); *In* re Grand Jury Subpoena, 357 F.3d 900, 907 (9th Cir. 2004). The Fifth Circuit employs a more stringent standard of review that affords attorney work product protection only when the "primary motivating purpose" for creating a document was "in anticipation of litigation." United States v. El Paso Co., 682 F.2d 530 (5th Cir. 1982), *cert. denied*, 466 U.S. 944 (1984). As has been pointed out by another commentator, regardless of whether the "because of" standard or the "primary motivating purpose" standard were used, FIN 48 tax accrual workpapers suffer from the same fatal characteristic regardless of which standard of review is employed in that they are routine business records that are created to meet a regulatory compliance purpose whether or not litigation may ensue. *See* Ventry, *A Primer on the Work Product Doctrine For Federal Courts*, 123 Tax Notes 875, 878 n.44, 2009 TNT 94-8 (May 18, 2009).

[123] United States v. Deloitte LLP, 610 F.3d 129 (D.C. Cir. 2010) Given that the Supreme Court specifically refused to create an accountant work product protection for tax accrual workpapers in the *Arthur Young* case, the DC Circuit's decision in the *Deloitte* case creates an incentive for taxpayers to use attorneys in lieu of accountants to create the FIN 48 tax accrual workpapers. Because this application of the attorney work product protection extends the scope beyond the limits placed by cases such as *Aldman* and *Roxoworthy,* provides privilege to work that serves an accounting function, and because this result directly contradicts the holdings in *El Paso* and *Textron,* the DC Circuit's decision in *Deloitte* should be viewed with suspicion.

[124] Frederick v. United States, 182 F.3d 496, 500 (7th Cir. 1999). *See also* United States v. BDO Seidman, 337 F.3d 802, 810 (7th Cir. 2003) (tax advice does not include communications regarding "tax return preparation); H.R. Conf. Rep. 105-599, at 267 (1998) (the privilege of confidentiality does not apply where the communication is made for further communication to third parties. For example, information that is communicated for inclusion in a tax return is not privileged because it is communicated for the purpose of disclosure). For a good discussion of the authorities in this area, see Martin McMahon and Ira Shepard, *Privilege and the Work Product Doctrine in Tax Cases,* 58 Tax Law. 405 (2005).

[125] *Frederick*, 182 F.3d at 500.

protection under the attorney work product protection because to provide a privilege in this instance would allow a taxpayer "to invoke, in effect, an accountant's privilege, provided that they used their lawyer to fill out their tax returns." The *Frederick* court reached this conclusion even though a document was in fact prepared in anticipation of litigation because the document was also used for the non-privileged purpose of tax return preparation.[126] In other words, if the taxpayer transmitted the attorney work product to the tax return preparer so that it could be used to complete the tax return, then such a use destroys "any expectation of confidentiality," which might otherwise have existed for its potential privileged use.[127] Other circuits have held that subjective decisions and advice related to how the tax return is prepared are simply not considered legal advice but instead accounting advice.[128] The privilege is not waived, however, when the taxpayer instructs the attorney to not use the information in preparing the tax return or where its use is left solely to the advisor's discretion.[129]

To what extent does the above case law control with respect to the preparation of final Schedule UTP? If attorney work product is used to evaluate uncertain tax positions on final Schedule UTP, does this use destroy "any expectation of confidentiality" with respect to these opinion documents? If this were the case, then the IRS through the implementation of this new filing requirement contained in final Schedule UTP will have unilaterally changed the contours of when the taxpayer can have an "expectation of confidentiality." Until further guidance is given in this area, this additional line of inquiry is almost certainly going to be another area of potential controversy in future litigation, and the decided cases are markedly against the taxpayer when the materials sought by the IRS were used to prepare and complete the tax return. Consequently, until clarified, taxpayers should consider the following practical questions as it designs processes to complete final Schedule UTP:

1. Should the person who prepares final Schedule UTP be a different person or the same person who prepares the tax disclosures for the financial statements?

2. Should the tax return preparer (even if that person is a company employee) be denied access to the company's FIN 48 workpapers and instead be given only summary information to use for the tax return preparation?

3. Should the person who prepares final Schedule UTP be the same person who prepared the attorney work product or should the tax return preparer be a different person?

Under existing case law on tax preparation materials, one would believe that the taxpayer may create additional risk if the tax return preparer is involved in the preparation of the

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[126] MICHAEL I. SALTZMAN, IRS PRACTICE AND PROCEDURE ¶ 13.11 (2d rev. ed. 2003).

[127] United States v. Lawless, 709 F.2d 485, 487-488 (7th Cir. 1983); *see also* United States v. Cote, 456 F.2d 142, 145 (8th Cir. 1972); Dorokee Co. v. United States, 697 F.2d 277, 280 (10th Cir. 1983); *but see* United States v. Schmidt, 360 F. Supp. 399, 347 (M.D. Pa. 1973) (holding contra to the main line of cases).

[128] *In re* Grand Jury Investigation, 842 F.2d 1223, 1224 (11th Cir. 1987); United States v. Gurtner, 474 F.2d 297, 299 (9th Cir. 1973).

[129] United States v. Threlkeld, 241 F. Supp. 324, 326 (W.D. Tenn. 1965); United States v. Baucus, 377 F. Supp. 468, 472 (D. Mont. 1974).

attorney work product, has access to the company's FIN 48 tax accrual workpapers, or is the same person who prepared the attorney work product materials.

However, even with these precautions, in the end, taxpayers should expect that the additional regulatory requirements, which are now required by SOX, and the additional tax return compliance requirements, required by new Schedule UTP, are going to significantly inhibit the availability of the attorney work product protection with respect to documents that are incorporated into those two compliance functions. As a result, taxpayers should again reach the same logical conclusion with respect to their tax planning and tax compliance processes, namely that these processes should be conducted under the belief that all tax positions will be fully understood and fully disclosed to the IRS. As a result, taxpayers and their advisors would be well advised to take corrective actions with respect to any areas in these processes that would not be able to withstand this level of transparency.

D. Enhanced Penalties for Failure to Adequately Disclose on Schedule UTP are on the Horizon

Congress has implemented significant legislation to raise the risk and the costs for taxpayers who fail to report a "listed transaction."[130] If a taxpayer fails to disclose a "listed transaction," then the period for assessment for this issue does not end until one year after the earlier of the time that the taxpayer files the information with the government, or a material advisor provides the information about the particular taxpayer to the IRS.[131] Congress also instituted specific penalties that apply to taxpayers that have an understatement with respect to an unreported listed transaction and indicated that the imposition of such penalties must be disclosed in a public company's filings with the U.S. Securities and Exchange Commission.[132] It is foreseeable that Congress would revisit these provisions, and through future legislation, would seek to extend their application to cover the failure to report uncertain tax position on final Schedule UTP.

VI. CONCLUDING THOUGHTS

The voluntary tax compliance system employed by the United States relies on the self-assessment of taxpayers of their own tax return.[133] Yet, at least historically, the nation's tax reporting standards generally have provided a lenient approach towards a taxpayer's self-assessment of its own tax liability such that a taxpayer need not believe in the sustainability of their own tax positions. Large taxpayers and sophisticated tax advisors have used this leniency to create significant underpayments versus the amount that these companies believe in their own judgment are due. The added transparency as a result of the issuance of FIN 48 and the adoption of SOX requirements has made it clear that the size of the tax under-reporting with

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[130] 26 U.S.C. § 6707A(c) (2006) (defining a listed transaction).

[131] See *Id.* § 6501(c)(10).

[132] *See Id.* §6662A(a); §6707A.

[133] Commissioner of Internal Revenue v. Lane Wells Co., 321 U.S. 219, 223 (1944) (recognizing that taxpayer self-assessment is the bedrock principle of the US tax system).

respect to unsustainable tax positions is significant. This situation is harmful to the public's perception about the voluntary self-assessment of large companies;[134] yet, the normal audit process has not allowed the IRS to effectively identify these areas of noncompliance.

The publication of final Schedule UTP is an interesting new chapter in tax compliance and the nation's efforts to reduce the tax gap. After the taxpayer signs the face of the tax return where the taxpayer swears under penalty of perjury that the information contained in the return is true, accurate, and complete, the taxpayer is now required to disclose on final Schedule UTP each of the unsustainable tax positions contained in the tax return. If a taxpayer fails to adequately disclose its uncertain tax positions on final Schedule UTP, one would expect that the IRS would request all of the taxpayer's FIN 48 tax accrual workpapers. Furthermore, one would expect Congress to further enhance penalties for failure to adequately complete final Schedule UTP, and Congress may also require taxpayers to only claim tax positions on their tax return that the taxpayer believes are sustainable.

As the nation struggles to address its budget deficit shortfalls, one would expect that efforts to reduce the "tax gap" will remain front and center in the nation's discourse. The wave of change is moving in a consistent direction: taxpayers must provide relevant information in a transparent manner to the IRS so that the IRS can quickly and efficiently determine the level of taxpayer compliance. Schedule UTP is a step in this direction, providing a signal that the intensity of change is accelerating.

Instead of resisting these transparency initiatives, large corporate taxpayers should embrace this change and implement tax practices that ensure that they are good corporate citizens that comply with their disclosure requirements in a transparent manner. Tax officers and their tax advisors should also seek to minimize the risk that their conduct opens up their client to potential tax whistleblower claims. To that end, taxpayers should conduct tax planning and tax compliance with the expectation that all tax positions will be fully understood and fully disclosed to the IRS. Tax planning and tax compliance that cannot withstand this rigorous level of transparency should be avoided immediately. Furthermore, tax officers and their tax advisors should encourage a culture of openness and transparency with respect to uncertain tax positions vis-à-vis the IRS and should take corrective actions immediately to eliminate areas where the taxpayer relies on unsustainable tax positions. Where reducing reliance on unsustainable tax positions requires the company to change the manner in which it conducts business, the tax function needs to immediately engage the company to make those changes. If business unit leaders cannot (or will not) change their business model to become less risky from a tax perspective, then the company should now recognize that in this age of transparency that it should not expect to reduce its overall tax cost by claiming unsustainable tax positions.

Once large corporate taxpayers adopt the above internal reforms, these taxpayers should then argue that all taxpayers, big or small, should be subject to the same standards of conduct when self-assessing and self-reporting their tax obligations. Tax reporting standards that promote full tax compliance serves the public good at a time when the country sorely needs to collect all the taxes that are legally due. Tax laws that do not promote this level of

[134] I.R.S. News Release 2008-137 (December 8, 2008) (stating that 80 percent of respondents believe that it is very important that IRS ensure that large corporations are reporting and paying their taxes honestly).

civic response should be changed. And in this age of transparency, this author believes that further reforms that require taxpayers to fully pay the taxes that they themselves believe are due will be forthcoming. The least risky course of conduct, given the direction of change, is for taxpayers to immediately limit the amount of tax benefits claimed on a tax return to only those amounts that are sustainable in the taxpayer's own judgment. In this age of increasing transparency, any lesser standard of tax reporting is likely to subject the taxpayer to an increasingly unacceptable level of criticism and risk.

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BANKRUPTCY LAW—WHETHER THE BANKRUPTCY COURT HAD THE STATUTORY AUTHORITY UNDER 28 U.S.C. § 157(b) TO ISSUE A FINAL JUDGMENT ON A TORTIOUS INTERFERENCE COUNTERCLAIM, AND WHETHER SUCH AUTHORITY IS CONSTITUTIONAl.

By Mira Hani Haykal*

Stern v. Marshall, 131 S. Ct. 2594 (U.S. 2011).

In June 2011, The United States Supreme Court held that although the Bankruptcy Court had the statutory authority to enter a final judgment on Vicky Lynn Marshall's tortious interference counterclaim, the court lacked constitutional authority.[1]

Vicki Lynn Marshall, publicly known as Anna Nicole Smith, married J. Howard Marshall nearly a year before his death. J. Howard Marshall was an oil executive and one of the richest men in Texas.[2] During their yearlong marriage, Vicki and J. Howard Marshall lived a lavish lifestyle; however, J. Howard Marshall never included Vicki Lynn in his will.[3] Vicki alleged that J. Howard intended to give her half of his estate.[4] After J. Howard's death, Vickie filed a petition for bankruptcy in the Central District of California.[5] Pierce Marshall then filed a complaint alleging that Vickie had defamed him by telling her lawyers to release to the press that Pierce was acting fraudulently in order to inherit all of his father's assets.[6] Vickie responded with a counterclaim for tortious interference, as she claimed that Pierce went against his father's wishes and wrongfully prevented J. Howard Marshall from giving her half of his estate.[7] Ultimately, the Court held that Bankruptcy judges are not the equivalent of Article III judges; thus, the Bankruptcy judge did not have the authority to enter final judgment on Vickie's claim.[8]

The Court took a plain text approach in holding that Vickie's tortious interference counterclaim against Pierce Marshall is a "core proceeding" under §157(b)(2)(C).[9] Congress gave United States district courts under 28 U.S.C. §1334(a), "original and exclusive jurisdiction of all cases under Title 11."[10] Bankruptcy courts may hear "all core proceedings arising under title 11 or arising in a case under title 11."[11] Section §157(b) provides a non-exhaustive list that includes 16 instances the Court recognizes as "core proceedings."[12] Specifically, §157(b)(2)(C) states that counterclaims "by the estate against persons filing claims against the

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[1] Stern v. Marshall, 131 S. Ct. 2594, 2608 (2011).

[2] *Id.* at 2600

[3] *Id.* at 2601.

[4] *Id.*

[5] *Id.*.

[6] *Id.*

[7] *Id.*

[8] *Id.* at 2620.

[9] 28 U.S.C. § 157(b)(2)(C) (2011).

[10] 28 U.S.C. §1334(a) (2011).

[11] 28 U.S.C. § 157(b)(1) (2011).

[12] *Id.* at § 157(b)(2).

estate" are core proceedings.[13] Thus, Vickie's tortious interference claim would fall directly under the statute. The Court cited and supported its suggestion in *Granfinanciera, S.A. v. Nordberg*, affirming that a proceeding's "core" status alone authorizes a bankruptcy judge to enter a final judgment.[14] The Court agreed with Vickie that the Bankruptcy Court was permitted to enter a final judgment on her counterclaim and rejected Pierce Marshall's theory that core proceedings fall under two classifications.[15]

Pierce argued that the language of §157(b)(1) provides for two classifications of core proceedings.[16] More specifically, Pierce alleged that because the statute speaks in terms of proceedings "arising in" and "arising under," Congress was specifically addressing a more narrow category of core proceedings. Pierce classified core matters that are neither "in" nor "under" a Title 11 case as "related to" a Title 11 case.[17] The Court quashed Pierce's argument explaining that Congress would have provided a framework for identifying "core" proceedings had it intended for multiple categories to exist.[18] Furthermore, Chief Justice Roberts stated that adopting Pierce's argument would be an "oxymoron," which "is not a typical feature of congressional drafting."[19] The only way in which Pierce could prevail would be for the Court to rewrite the statute, which would be a violation of separation of powers.[20]

Despite the Court's holding that §157(b)(2)(C) provides the Bankruptcy Court with authority to enter final judgment under Vickie Marshall's counterclaim, the Court held that Article III of the Constitution does not give such authority.[21] In forming its holding, the Supreme Court cited and supported its decision in *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, in which bankruptcy judges serving under the Bankruptcy Act of 1978 were not found to have the constitutional authority to decide a state-law contract claim against an entity that was not part of the bankruptcy proceedings.[22] In *Northern Pipeline*, the court acknowledged that there were cases that involved "public rights" that Congress could constitutionally send to legislative courts. However, the "public rights" exception extended only to matters arising between individuals and the government that could only be decided by either the executive or legislative branches.[23]

In entering final judgment on Vickie Marshall's state claim, the Bankruptcy Court exercised the powers delegated to Article III courts in the absence of a "public right" exception.[24] The Court has applied the "public right" exception in limited situations.[25] Chief Justice Roberts labeled Article III courts as "experts" in handling Vickie's counterclaim.[26] Congress did not establish a specialized means for handling questions such as Vickie's.[27] What makes a right "public" as opposed to private is that the right is "integrally related to particular federal

[13] *Id.* at § 157(b)(2)(C).

[14] *Marshall,* 131 S.Ct. at 2604 (citing Granfinanciera v. Nordberg, 492 U.S. 33, 50 (U.S. 1989)).

[15] 131 S. Ct. at 2605.

[16] *Id.*

[17] *Id.*

[18] *Id.*

[19] *Id.*

[20] *Id.*

[21] *Id.* at 2608.

[22] *Id.* (citing N. Pipeline Constr. Co. v. Marathon Pipe Line Co., 458 U.S. 50, 58 (U.S. 1982)).

[23] *Id.* (citing *N. Pipeline,* 458 U.S. at 67-68.

[24] *Marshall,* 131 S. Ct. at 2611.

[25] *Id.* at 2612-2614.

[26] *Id.* at 2615.

[27] *Id.*

government action."[28] The Court in *Granfinanciera* held that a fraudulent conveyance claim neither belongs to nor exists against the Federal Government; thus, Article III courts alone have the authority to enter final judgment.[29] Like in *Granfinanciera*, Vickie's tortious interference claim is not at the mercy of the other branches of government, nor is the claim one that historically could have been heard exclusively by another branch.[30] The claim lies exclusively with the state, and it is completely independent of Vickie's bankruptcy claim.[31] In Justice Scalia's concurrence, he reaffirms his concurrence in *Granfianciera* maintaining that, "a matter of public rights must at a minimum arise between the government and others."[32] Vickie's claim was not tied to a federal regulatory scheme, nor was it "completely dependent upon" adjudication of a claim established by federal law.[33] The tortious interference claim is governed by state common law and involves two private parties, so the matter is not one of "public right."[34]

In addition to rejecting Vickie's claim that the Bankruptcy Court had constitutional authority to hear her case under the "public right" exception, the Court also rejected her argument that bankruptcy courts under the Bankruptcy Act of 1984 were able to participate as adjuncts of Article III courts.[35] Chief Justice Roberts explained that just as a district court cannot be deemed an adjunct of the court of appeals, a bankruptcy court is not an adjunct of the district court.[36] Bankruptcy judges have the authority to enter final judgments, and their authority should be given credence.[37]

Lastly, the Court rejected Vickie's assertion that restrictions on the bankruptcy courts' ability to enter final judgments on compulsory counterclaims will cause great delay to the court system.[38] Chief Justice Roberts emphasized that an efficiency argument cannot prevail if it conflicts with the Constitution, and the Bankruptcy Court's final judgment directly violates Article III of the Constitution.[39]

After over fifteen years of feuding in the courts, Vickie Lynn Marshall, Pierce Marshall, and J. Howard Marshall have all passed away. However, the legacy of this lengthy court battle will forever be a reminder that the Constitution is the ultimate legal authority in the United States. Any law, principle, or policy that contradicts the supreme law of our land cannot stand. This case has weighed heavily upon the scales of the United States court system, as an estimated twenty percent of Delaware Bankruptcy decisions in the past three months have referred to the decision in this case.[40]

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[28] *Id.* at 2613.

[29] *Id.* at 2614 (citing *Granfinanciera,* 492 U.S. at 54-55).

[30] 131 S. Ct. at 2614.

[31] *Id.*

[32] *Id.* at 2620.

[33] *Id.* at 2614 (quoting Commodity Futures Trading Com. v. Schor, 478 U.S. 833, 856 (U.S. 1986)).

[34] *Id.*

[35] *Id.* at 2618-19.

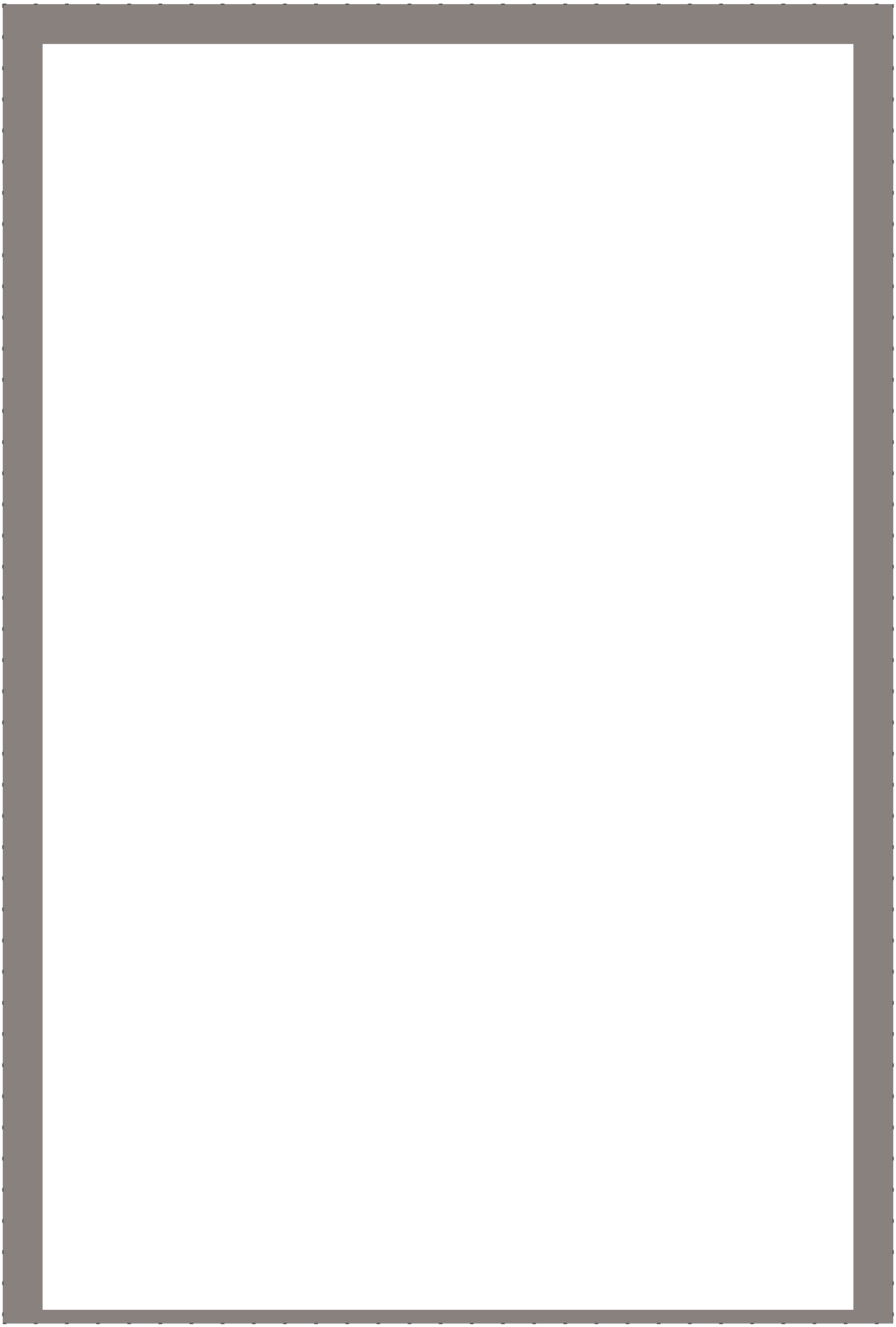
[36] *Id.* at 2619.

[37] *Id.*

[38] *Id.*

[39] *Id.*

[40] John L. Bird, *Stern v. Marshall: Effects on Delaware* (September 8, 2011), http://delawarebankruptcy.foxrothschild.com/2011/09/articles/opinions/stern-v-marshall-effects-on-delaware/.



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BANKRUPCTY LAW—WHETHER A DEBTOR-IN-POSSESSION CAN AVOID A PRE-PETITION REAL PROPERTY FORECLOSURE THAT COMPLIESWITH STATE LAW AND IS NON-COLLUSIVE ON THE GROUNDS THAT THE FORECLOSURE CONSTITUTED A PREFERENTIAL TRANSFER.

By David E. Brezik*

***Whittle Dev., Inc. v. Branch Banking Trust Co.* (*In Re Whittle Dev., Inc.*)**, Case No. 10-37084-HDH-11, Adv. No. 11-03150, 2011 Bankr. LEXIS 2956 (Bankr. N.D. Tex. July 27, 2011).

In July 2011, the United States Bankruptcy Court for the Northern District of Texas, Dallas Division, denied a creditor bank's motion to dismiss the complaint, filed by a debtor-in-possession seeking to avoid the bank's pre-petition foreclosure on the debtor's real property.[1] In doing so, the court held that a Chapter 11 debtor-in-possession can avoid a pre-petition foreclosure on the grounds that the foreclosure constituted a preferential transfer, even though the foreclosure complied with state law and was non-collusive.[2]

In December 2009 Whittle Development, Inc. (Whittle) and Colonial Bank, N.A. (Colonial) entered into a Development Loan Agreement in which Colonial agreed to loan Whittle $2,700,000, secured by real property owned by Whittle.[3] Colonial was later acquired by Branch Banking and Trust Company (BB&T), who became the successor in interest to Colonial.[4] In 2010, BB&T declared Whittle in default on its loan, accelerated payments, and notified Whittle of its intent to foreclose on the property securing the loan.[5] On September 7, 2010, BB&T foreclosed on the property in a sale that was stipulated by both parties as having complied with all relevant Texas requirements for a valid foreclosure.[6] Upon foreclosure, the property was sold to Eagle TX I SPE, LLC, a subsidiary of BB&T, for $1,220,000.[7]

On October 4, 2010, Whittle filed a petition under Chapter 11 of Title 11 of the United States Code (Bankruptcy Code), claiming that the approximate value of the property secured by the loan was $3,300,000.[8] Whittle argued that BB&T was over secured by $1,100,000 because, at the time of the foreclosure sale, BB&T's claim on the property was approximately $2,200,000.[9] In response, on February 7, 2011 BB&T filed a proof of claim in the bankruptcy case in the amount of $2,855,243.29.[10] BB&T alleged that, in addition to the $1,220,000 it received from the foreclosure sale, it was also entitled to $1,181,513.27, which constituted the deficiency from the foreclosure sale.[11]

The court began its analysis with an examination of federal principles regarding preferential transfers. "A preference is a transfer that enables a creditor to receive payment of a greater percentage of his claim against the debtor than he would have received if the transfer

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[1] Whittle Dev., Inc. v. Branch Banking Trust Co. (In Re Whittle Dev., Inc.), Case No. 10-37084-HDH-11, Adv. No. 11-03150, 2011 Bankr. LEXIS 2956, at *17-18 (Bankr. N.D. Tex. July 27, 2011).

[2] *Id.* at *17.

[3] *Id.* at *2-3.

[4] *Id.*

[5] *Id.* at *3.

[6] *Id.*

[7] *Id.*

[8] *Id.*

[9] *Id.*

[10] *Id.*

[11] *Id.*

had not been made and he had participated in the distribution of the assets of the bankruptcy estate."[12] However, the court noted that the Bankruptcy Code contains a statutory mechanism which allows for a trustee or debtor-in-possession to avoid these pre-petition transfers deemed to be preferential. Section 547(b) of the Bankruptcy Code provides that a trustee or debtor-in-possession may avoid a transfer of an interest of the debtor in property that enables a creditor to receive more than the creditor would receive if the property were disposed of in accordance with chapter 7 of the Bankruptcy Code.[13] Further, the court noted that the basic goals of this code provision are to facilitate and secure the equal distribution of the debtor's assets among his creditors[14] and to discourage these creditors from "racing to the courthouse to dismember the debtor as they slide into bankruptcy."[15]

The parties disagreed as to whether Whittle met the requirements of section 547(b), specifically subsection (b)(5), in order to avoid the preferential sale of the property. Subsection (b)(5) requires a finding that the creditor received more during the foreclosure sale than it would under chapter 7 of the Bankruptcy Code.[16] BB&T argued that subsection (b)(5) could not be satisfied as a matter of law because of the Supreme Court's decision in *BFP v. Resolution Trust Corp*.[17] In *BFP*, the U.S. Supreme court held that "a fair and proper price, or a 'reasonably equivalent value,' for foreclosed property, is the price in fact received at the foreclosure sale, so long as all the requirements of the State's foreclosure law have been complied with."[18] Thus, it was BB&T's contention that the price it received at the foreclosure sale was, as a matter of law, the fair market value for the property and that Whittle failed to meet the requirements of section 547(b) to avoid the transfer.[19]

Whittle argued that BB&T was over secured by more than $1,000,000 and received more through the foreclosure sale than they would have under chapter 7 because the property was worth more than the amount Whittle owed to BB&T.[20] Whittle asserted that BB&T received claims and real property with an aggregate net value of $3,261,513.27, in satisfaction of a debt that amounted to no more than $2,220,000 (the maximum that BB&T would have been able to recover under a chapter 7 of the Bankruptcy Code).[21] Additionally, Whittle argued that BB&T misplaced its reliance on the Supreme Court's decision in *BFP* because the dispute in that case involved the issue of whether a foreclosure sale could be avoided as a fraudulent conveyance under section 548 of the Bankruptcy Code. Whittle asserted that section 548 could not be used in the preference context, such as in this case, because the statutory language in sections 547 and 548 are not the same and concern different points in time.[22] Thus, as a result of BB&T's receiving more under the foreclosure sale than they would under chapter 7, Whittle argued that the foreclosure sale constituted a preferential transfer and, under section 547(b), was avoidable.[23]

Addressing the arguments of the parties, the court noted that in the context of bankruptcy cases, statutory analysis ends with the text if the language of the statue is "clear and

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[12] *Id.* at *5 (citing Barrett Dodge Chrysler Plymouth, Inc. v. Cranshaw (In re Issac Leaseco, Inc.), 389 F.3d 1205, 1209 (11th Cir. 2004) (quoting Union Bank v. Wolas, 502 U.S. 151, 160-61 (1991))).
[13] 11 U.S.C. § 547(b) (LexisNexis 2011).
[14] *Whittle*, 2011 Bankr. LEXIS 2956 at *5-6.
[15] *Id.*
[16] 11 U.S.C. § 547(b)(5)(A).
[17] *Whittle*, 2011 Bankr. LEXIS 2956 at *8.
[18] BFP v. Resolution Trust Corp., 511 U.S. 531, 545 (1994).
[19] *Whittle*, 2011 Bankr. LEXIS 2956 at *8.
[20] *Id.*
[21] *Id.*
[22] *Id.* at *8-9.
[23] *Id.* at *9-10.

does not lead to an absurd result."[24] All Whittle had to show in this case was that BB&T did receive more from the pre-petition transfer than it would have under chapter 7 in order for the section 547(b)(5)(A) to be satisfied.[25] However, in its discussion the court pointed out that there is a disagreement among the jurisdictions concerning the applicability of the *BFP* decision in the context of section 547(b).

As illustrated by the court, some courts follow the approach taken in *In re Villareal*, in which the trial judge found a creditor's $3,250,000 windfall from a foreclosure sale avoidable notwithstanding the fact that the foreclosure sale was non-collusive and complied with state laws.[26] In that case the court took the approach, as Whittle argued in this case, that if the amount obtained through the foreclosure sale was less than the hypothetical amount that the court deems would have been recovered under chapter 7, the requirements of section 547(b) have been met.[27] The court in *Whittle* then noted that other courts have found that *BFP* is inapplicable in the section 547(b) context.[28]

As observed in Whittle, other courts have disagreed. For these courts, federalism concerns override the application of section 547 and it is suggested that, by allowing a debtor to avoid a foreclosure, state interests would be undermined where foreclosure sale complied with state law.[29] As seen in *BFP*, the Supreme Court declined to measure "reasonably equivalent value" according to any valuation method other than the price received at a complying foreclosure sale because they believed that this would have infringed upon an important state interest, the security of titles to real estate, by overshadowing it with a "federally created cloud" on all property bought and sold through foreclosure sales.[30] Despite the concerns of some courts, the *Whittle* court held that BB&T's reliance on the *BFP* case was misplaced, finding that the issue addressed in *BFP* was the meaning of "reasonably equivalent value" in section 548(a)(2) of the Bankruptcy Code, which was not an issue before this court.[31] The court noted that the question before the court was simply one of avoidance: "whether the creditor did in fact received more than it would have had the transfer not occurred."[32]

The *Whittle* court posited that the "optimal approach" to this issue is that if an otherwise valid foreclosure sale is found to enable a creditor to obtain more than he would in a chapter 7 liquidation, then any additional amount of benefit conferred to that creditor would simply be brought back into the estate.[33] Under this approach, the court suggests that state interests in the securing of titles would be furthered without subverting the policy behind the Bankruptcy Code of ensuring equality among creditors.[34] Further, the court stated that this approach would pose no risk to third-party purchasers of foreclosed property because a purchaser without a claim against the debtor would fall within the protection of section 547(b)(1),[35] which only allows avoidance of transfers "to or for the benefit of a creditor."[36] For these reasons and because the Code provides for a distinction between the creditor and the third party

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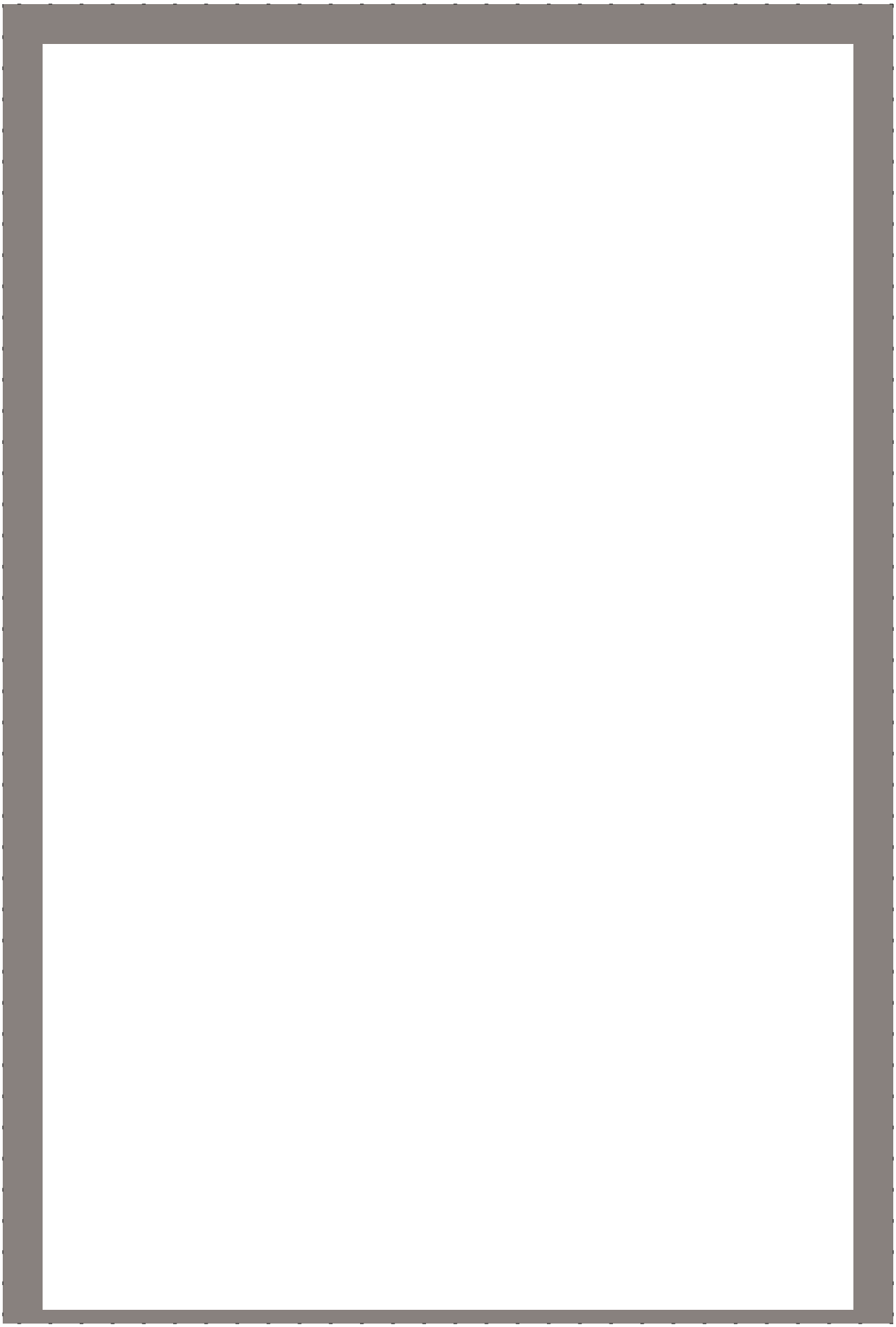
[24] *Id.* at *9.
[25] *Id.* at *9-10.
[26] *Id.* at *10. (*See* Villarreal v. Showalter (*In re* Villarreal), 413 B.R. 633 (Bankr. S.D. Tex. 2009)).
[27] *Villarreal*, 413 B.R. at 642.
[28] *Whittle*, 2011 Bankr. LEXIS 2956 at *10-11.
[29] *Id.* at *12.
[30] *Id.* at *11 (quoting BFP v. Resolution Trust Corp., 511 U.S. 531, 544 (1994)).
[31] *Id.* at *13.
[32] *Id.*
[33] *Id.* at *14.
[34] *Id.*
[35] *Id.* at *16.
[36] 11 U.S.C. § 547(b)(1) (LexisNexis 2011).

bona fide purchaser, this court stated that the concerns addressed in *BFP* are a non-issue in the context of section 547 avoidance actions.[37]

Following from its analysis, the *Whittle* court held that a chapter 11 debtor-in-possession can avoid a pre-petition foreclosure that was non-collusive and complied with state law on the grounds that the foreclosure sale constituted a preferential transfer.[38] The court found *BFP* inapplicable in this case because section 547 allows the avoidance of a foreclosure sale.[39] Additionally, the court found that the federalism concerns noted in *BFP* and subsequent cases do not apply to section 547 actions.[40] Thus, because Whittle had set out a claim that was facially plausible with regard to BB&T's foreclosure sale, the court held that BB&T's motion to dismiss was denied.[41]

[37] *Whittle*, 2011 Bankr. LEXIS 2956 at *16-17.
[38] *Id.* at *17.
[39] *Id.*
[40] *Id.*
[41] *Id.* at *18.



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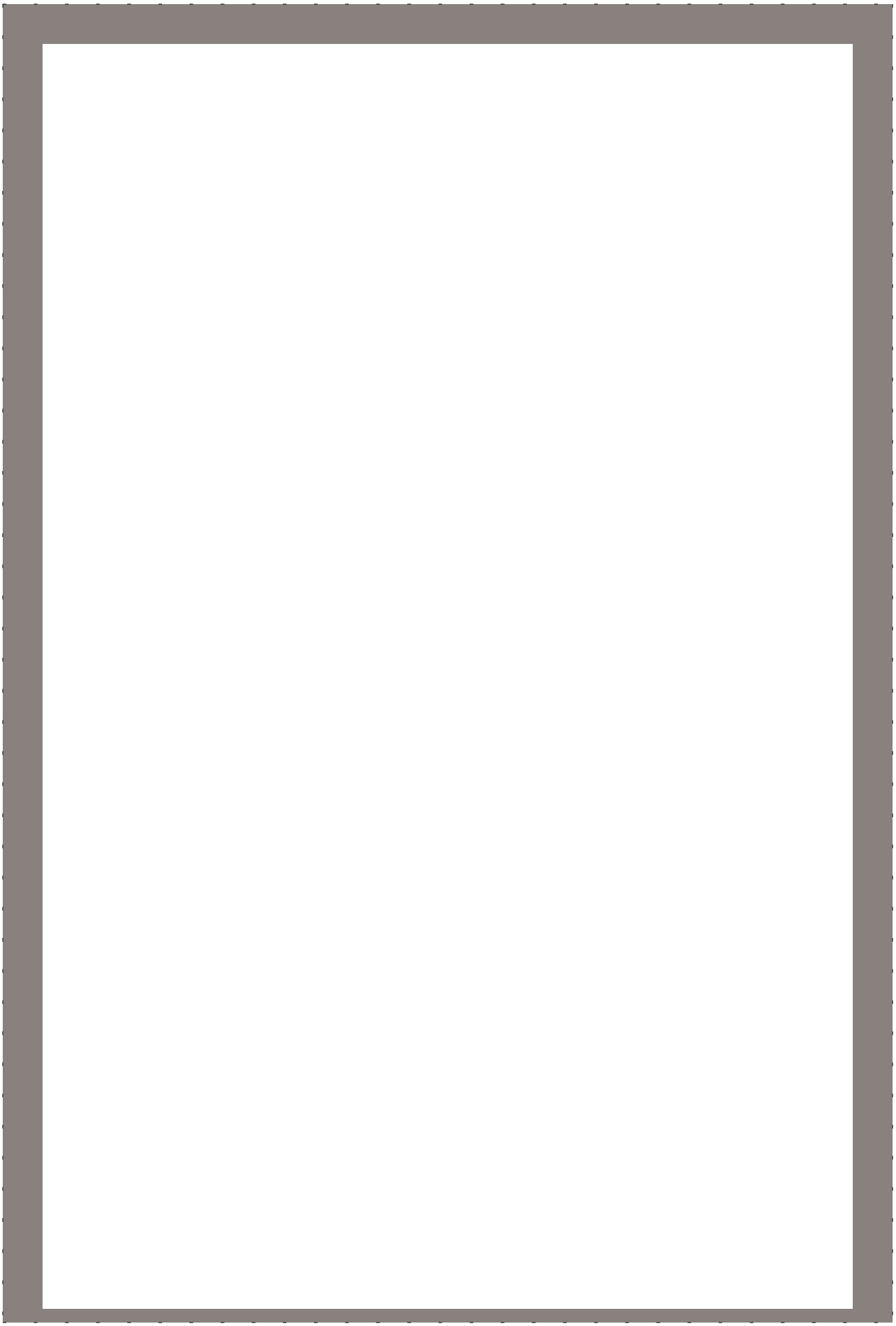

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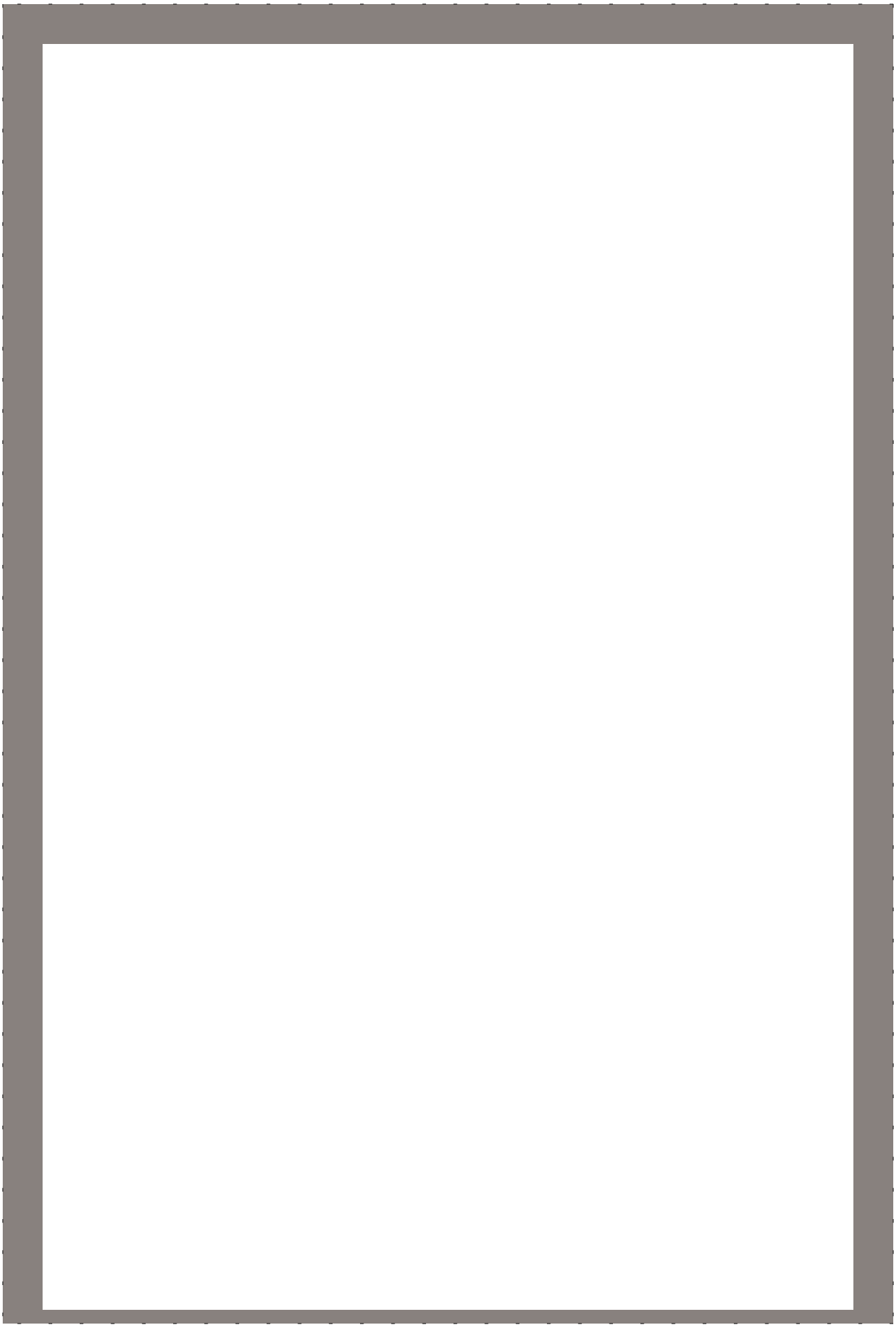

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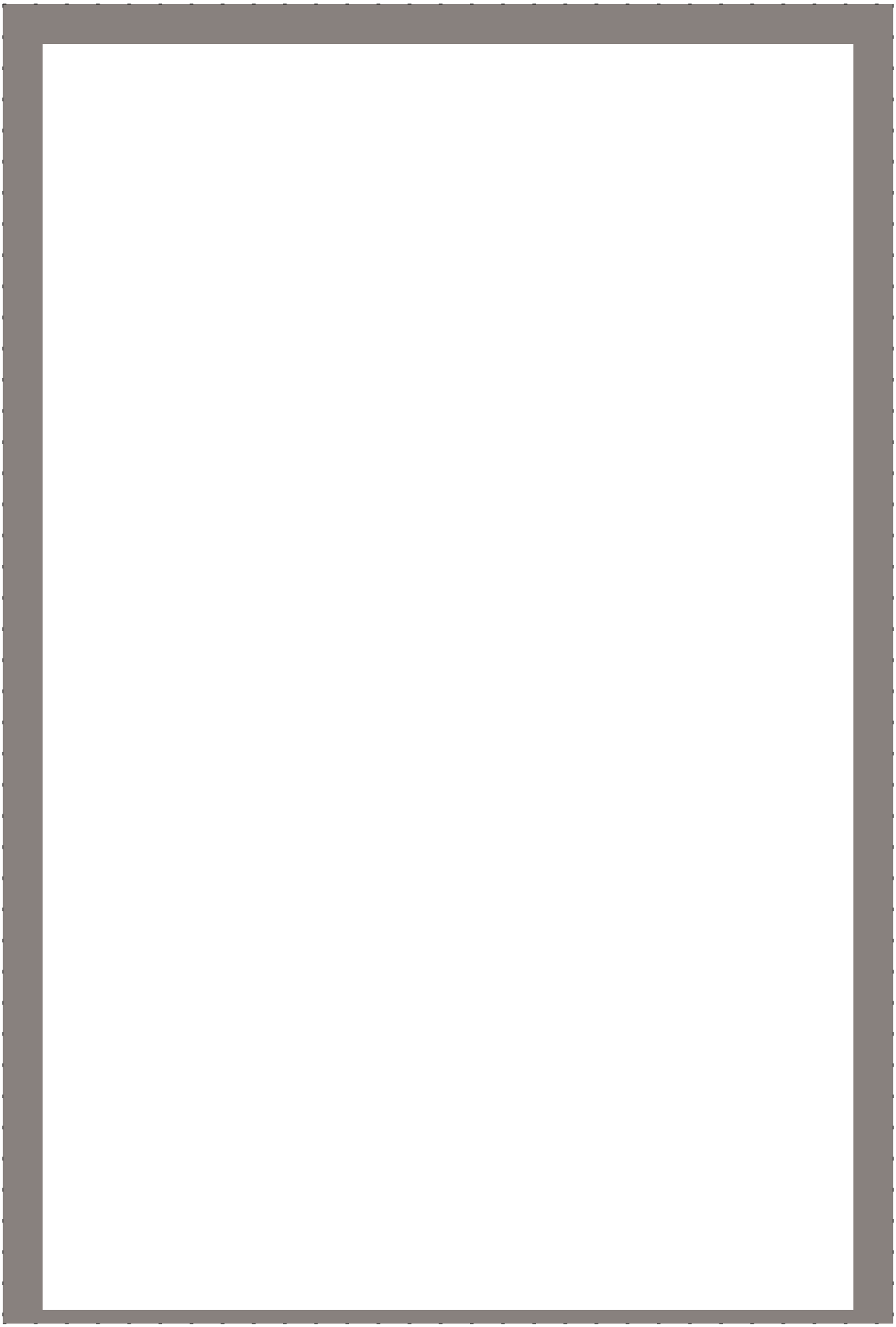

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