TEXAS JOURNAL OF BUSINESS LAW

Volume 45 Spring 2013 Number 2

CONTENTS:

(U.S. ISSN 1547-3619)

Cite as: TEX. J. BUS. L.

ABOUT THE JOURNAL

The **TEXAS JOURNAL OF BUSINESS LAW** is dedicated to providing Texas attorneys and academics with comprehensive, up-to-date coverage of the ever-changing and rapidly expanding field of business law. The Journal presently has over 4,000 subscribers, making it one of the most widely circulated student-run publications in Texas, as well as one of the largest business law journals in the nation. The Journal is also the official publication of the Business Law Section of the State Bar of Texas. Please visit the Business Law Section's website at http://texasbusinesslaw.org.

MISSION STATEMENT

The mission of the **TEXAS JOURNAL OF BUSINESS LAW** is to serve as a leading source in the practice of business law in Texas. The Journal is dedicated to providing comprehensive, practical, and current information for practicing attorneys, judges, students, and academics. To this end, the Journal will strive to provide accurate, reliable, and contemporary information regarding the practice of business law in Texas.

In order to assure the ability to provide quality information, the Journal will select only the highest quality student members and will provide an invaluable learning and support network for students.

SUBMISSIONS

The **TEXAS JOURNAL OF BUSINESS LAW** welcomes article submissions from judges, practitioners, and academics. Articles should address an area of business law relevant to Texas legal practitioners and be written in a style suitable for a law journal. Article submissions must be in Microsoft Word format, include a Table of Contents, include an Abstract, contain footnotes rather than endnotes, and conform to both *The Bluebook: A Uniform System of Citation* (19th ed.) and the *Texas Rules of Form* (12th ed.). Submissions should be addressed to:

Texas Journal of Business Law
Attn: Submissions
C/O South Texas College of Law
1303 San Jacinto Street, Suite 307
Houston, Texas 77002

Please include a hard copy of the article, an article abstract, and CD with both the article and the abstract. Alternatively, submissions may be made electronically via email to tjblawme@stcl.edu. All submissions are reviewed by a committee composed of student Journal members, faculty advisers, and practitioners in the Business Law Section of the State Bar of Texas.

SUBSCRIPTIONS

A subscription to the **TEXAS JOURNAL OF BUSINESS LAW** is included as a benefit of membership in the Business Law Section of the State Bar of Texas. For an additional subscription to the Journal, or to subscribe without joining the Section, please contact the Sections Department of the State Bar of Texas at 1-800-204-2222 or at:

State Bar of Texas
Attn: Sections Department
P.O. Box 12487
Austin, Texas 78711

REPRINTS

For back issues, please contact:

Texas Journal of Business Law
Attn: Reprints
C/O South Texas College of Law
1303 San Jacinto Street, Suite 307
Houston, Texas 77002
tjblawme@stcl.edu

TEXAS JOURNAL OF BUSINESS LAW

Volume 45 Spring 2013 Number 2

TEXAS JOURNAL OF BUSINESS LAW

Volume 45 Spring 2013 Number 2

TEXAS JOURNAL OF BUSINESS LAW

Volume 45 | Spring 2013 | Number 2

RESTORING THE BALANCE OF CLASS CERTIFICATION POWER IN THE FIFTH CIRCUIT: THE UNITED STATES SUPREME COURT'S OPINION IN *ERICA P. JOHN FUND, INC. V. HALLIBURTON, CO.*

Roger B. Greenberg & Thane Tyler Sponsel III*

The Fifth Circuit, like other circuits, occasionally finds itself in conflict with the other circuit courts. *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*[1] and *Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co*.[2] created one of these conflicts in the context of class certification under Federal Rule of Civil Procedure 23. On June 6, 2011, the United States Supreme Court resolved this conflict with its unanimous decision in *Erica P. John Fund, Inc. v. Halliburton Co.*[3]

In *Oscar* and *Halliburton*, the Fifth Circuit held that in addition to proving all of the Federal Rule of Civil Procedure ("FRCP") 23 requirements, a putative securities class must prove loss causation by a preponderance of all admissible evidence before class certification may be granted.[4] This was an exceedingly high burden and was noted as such by district courts within the Fifth Circuit, including twice by District Judge Barbara M.G. Lynn in the District Court's *Halliburton* opinion.[5] The Supreme Court apparently agreed with Judge Lynn that the burden was "exceedingly high" and overruled the Fifth Circuit's decisions in *Oscar* and *Halliburton*: "[t]he question presented in this case is whether securities fraud plaintiffs must also prove loss causation in order to obtain class certification…. [w]e hold that they need not."[6]

The plaintiff filed *Halliburton* on June 3, 2002 in the Northern District of Texas. After proceeding for nearly six years, a hearing on class certification was held on March 21, 2008. The District Court found all elements of Rule 23 agreed to by the parties and satisfied, but denied class certification because the Plaintiffs had not demonstrated the Fifth Circuit's additional requirement of loss causation by a preponderance of all admissible evidence.[7] On February 12, 2010, the Fifth Circuit agreed and affirmed the District Court's conclusion that the class certification motion failed for want of establishing loss causation.[8]

---

* Roger B. Greenberg is a named partner with Schwartz, Junell, Greenberg & Oathout, LLP in Houston, Texas. Mr. Greenberg has handled a broad range of civil trial cases involving Securities, Arbitrations, Energy, Intellectual Property, Banking, Financial and Accounting matters. He is admitted to practice in Texas state courts, the Supreme Court of Texas, the United States District Courts for the Northern, Southern, Eastern and Western Districts of Texas, the Fifth, Ninth and Eleventh Circuit Courts of Appeals, and the United States Supreme Court.

Thane Tyler Sponsel III is an attorney with Schwartz, Junell, Greenberg & Oathout, LLP in Houston, Texas. Mr. Sponsel has handled a broad range of civil cases involving Securities, Energy, Construction, Real Estate, Contracts, Liens and Debt Collection matters. He is admitted to practice in Texas state courts, the Supreme Court of Texas, and the United States District Courts for the Northern and Southern Districts of Texas.

[1] 487 F.3d 261 (5th Cir. 2007).

[2] 597 F.3d 330 (5th Cir. 2010).

[3] 131 S. Ct. 2179 (2011).

[4] *See Oscar*, 487 F.3d at 269; *Archdiocese of Milwaukee*, 597 F.3d at 335.

[5] *See* Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co., No. 3:02CV1152M, 2008 WL 4791492, *2, *20 (N.D. Tex. Nov. 4, 2008).

[6] *See Erica P. John Fund*, 131 S. Ct. at 2183.

[7] *See Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.*, 2008 WL 4791492, at *1.

[8] *See Archdiocese of Milwaukee*, 597 F.3d at 344.

Erica P. John Fund, Inc. v. Halliburton Co.[9]

Chief Justice Roberts, writing for a unanimous Supreme Court, began with a concise holding, narrowly focusing and limiting the opinion:

> To prevail on the merits in a private securities fraud action, investors must demonstrate that the defendant's deceptive conduct caused their claimed economic loss. This requirement is commonly referred to as "loss causation." The question presented in this case is whether securities fraud plaintiffs must also prove loss causation in order to obtain class certification. We hold that they need not.[10]

The Supreme Court's decision overruled the Fifth Circuit's *Oscar* and *Halliburton* decisions and brought the Fifth Circuit in line with the remainder of the federal circuits where loss causation proof was not required to obtain class certification. However, the Supreme Court clarified that it was not addressing any other question about the fraud-on-the-market presumption or how and when it may be rebutted.[11]

In this case, plaintiffs alleged that Halliburton violated section 10(b) of the Securities Exchange Act of 1934 and Securities and Exchange Commission Rule 10b-5 when it deliberately made false statements about "(1) the scope of its potential liability in asbestos litigation, (2) its expected revenue from certain construction contracts, and (3) the benefits of its merger with another company."[12] After defeating a motion to dismiss, the lead plaintiff sought class certification under Rule 23.[13] As stated above, the Supreme Court noted that the District Court found all elements of Rule 23(a) were satisfied and that the action could proceed as a class action under Rule 23(b)(3), but for the problem that Fifth Circuit "precedent required securities fraud plaintiffs to prove 'loss causation' in order to obtain class certification."[14]

The Supreme Court thus focused on the sole dispute, whether the lead plaintiff had satisfied the prerequisites of Rule 23(b)(3).[15] Rule 23(b)(3) requires that courts find that "questions of law or fact common to class members predominate over any questions affecting only individual members, and that a class action is superior to other available methods for fairly and efficiently adjudicating the controversy."[16] These requirements are sometimes referred to as predominance and superiority. When courts are considering the predominance requirement, *i.e.* whether common questions of law or fact predominate, the starting block is the elements of the underlying cause of action. Here, plaintiffs had alleged violations of section 10(b) and Rule 10b-5, which require proof of: "(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation."[17] Chief Justice Roberts correctly noted that whether

---

[9] 131 S. Ct. 2179 (2011).

[10] *Id*. at 2183.

[11] *See id.* at 2187.

[12] *See id.* at 2183.

[13] *See id*.

[14] *See id.*

[15] *Id*. at 2184.

[16] *Id*. (citing FED. R. CIV. P. 23(b)(3)).

[17] *Id*. at 2184.

common questions of law or fact predominate in a securities fraud action often turns on the element of reliance.[18]

The Supreme Court then focused on its creation in *Basic Inc. v. Levinson*[19] of the fraud-on-the-market presumption of reliance.[20] According to the high court, the traditional, single plaintiff manner of proving reliance is a showing that a plaintiff was aware of a company's statement and purchased stock based on that specific misrepresentation.[21] However, in *Basic*, the Supreme Court realized that this traditional method of proving reliance "effectively would prevent such plaintiffs from proceeding with a class action, since individual issues would overwhelm the common ones."[22] Therefore, the *Basic* court created a rebuttable presumption of reliance, *i.e.* the fraud-on-the-market theory, which stated that the market price of shares traded on an efficient market reflects all publicly available information, including any material misrepresentations, and because the market transmits information to investors in the processed form of a market price, courts can presume that an investor relied on the public misstatements whenever he bought or sold stock at the market price.[23] In order for plaintiffs to invoke this rebuttable presumption of reliance, plaintiffs must demonstrate that the alleged misstatements were publicly known, "that the stock traded in an efficient market, and that the relevant transaction took place 'between the time the misrepresentations were made and the time the truth was revealed.'"[24] Thus, once proved, plaintiffs are entitled to a rebuttable presumption of reliance, referred to as transaction causation by the Supreme Court, and common issues of reliance will predominate over individual ones.[25]

In *Halliburton*, the Fifth Circuit's error was requiring additional proof of loss causation.[26] Chief Justice Roberts noted that the Supreme Court had "never before mentioned loss causation as a precondition for invoking *Basic*'s rebuttable presumption of reliance … [and that t]he term loss causation does not even appear in [the] *Basic* opinion."[27] Reliance (or transaction causation) focuses on "facts surrounding the investor's decision to engage in the transaction," while loss causation, according to the Supreme Court, "requires a plaintiff to show that a misrepresentation…affected the…market price [and] caused a subsequent economic loss."[28] These are two distinct concepts of securities law and the Supreme Court delineated the two stating that "[l]oss causation has no logical connection to the facts necessary to establish the efficient market predicate to the fraud-on-the-market theory."[29]

Realizing that proof of loss causation at the class certification stage was to be short lived, Halliburton conceded that "securities fraud plaintiffs should not be required to prove loss causation in order to invoke *Basic*'s presumption of reliance."[30] Halliburton contended that the

---

[18] *Id*.

[19] 485 U.S. 224 (1988).

[20] Erica P. John Fund, Inc. v. Halliburton, Co., 131 S. Ct. 2179, 2185 (2011).

[21] *Id*.

[22] *Id*. (quotations omitted).

[23] *Id.*

[24] *Id*. at 2185 (citing *Basic*, 485 U.S. at 248 n.27).

[25] *See e.g., Erica P. John Fund*, 131 S. Ct. at 2185–86.

[26] *Id*. at 2185–86.

[27] *Id*. at 2186.

[28] *Id*.

[29] *Id*.

[30] *Id*.

Fifth Circuit's use of "loss causation" was "shorthand for a different analysis," and the actual inquiry was whether the lead plaintiff had demonstrated price impact.[31] According to the Supreme Court, price impact refers to the effect of a misrepresentation on a stock price, and it was Halliburton's theory "that if a misrepresentation does not affect market price, an investor cannot be said to have relied on the misrepresentation merely because he purchased stock at that price."[32] The Supreme Court made short work of this theory explaining that loss causation and price impact, while the legal concepts share some consistent language, are in fact distinct legal concepts, and the Supreme Court could not ignore the Fifth Circuit's "repeated and explicit references to 'loss causation.'"[33]

Following this matter-of-fact pronouncement, the Supreme Court vacated the Fifth Circuit's judgment and limited its holding to the loss causation issue.[34] "Because we conclude the Court of Appeals erred by requiring EPJ Fund to prove loss causation at the certification stage, we need not, and do not, address any other question about *Basic*, its presumption, or how and when it may be rebutted."[35]

The Supreme Court's decision brought the Fifth Circuit back in line with the other circuits that did not require proof of loss causation.[36] However, the Supreme Court oral argument underscores the narrow scope of the holding, which left the door open for Halliburton's argument that it rebutted the presumption of class wide reliance by proving lack of "price impact."

During oral argument, Justice Kagan had an exchange with Halliburton's counsel that clarified Halliburton's position. Justice Kagan asked Halliburton's counsel what argument it was making in its brief:

> One possible argument you could be making is that the plaintiffs have to show a price impact. Another possible argument you could be making is that you have to have the opportunity to rebut the plaintiff's use of the *Basic* presumption by yourself showing that there was no price impact.[37]

Halliburton's counsel clarified that it was not the first argument:

> *Basic* puts the initial burden on the defendant to show the absence of price impact, showing that the presumed fact does not exist. Once that threshold showing is made, the burden remains on the plaintiff under Rule 301 and Rule 23 to show by a preponderance of the evidence that the market price was in fact, distorted.[38]

---

[31] *Id*. at 2186–87 (quotations omitted).

[32] *Id*. at 2187.

[33] *Id*. (further stating "[w]hatever Halliburton thinks the Court of Appeals meant to say, what it said was loss causation… [w]e take the Court of Appeals at its word… [b]ased on those words, the decision below cannot stand.").

[34] *Id*. at 2187.

[35] *Id*.

[36] *See id*. at 2184 (citing *In re* Salomon Analyst Metromedia Litig., 544 F.3d 474, 483 (2d Cir. 2008) (not requiring investors to prove loss causation at class certification stage); Schleicher v. Wendt, 618 F.3d 679, 687 (7th Cir. 2010) (same); *In re* DVI, Inc. Sec. Litig., 639 F.3d 623, 636–37 (3d Cir. 2011) (same; decided after certiorari was granted)).

[37] Transcript of Oral Argument at 27–28, Erica P. John Fund, Inc. v. Halliburton Co., 131 S. Ct. 2179 (2011) (No. 09-1403).

[38] *Id.* at 28.

This exchange suggests that Halliburton was not arguing that the Fifth Circuit simply meant price impact when it said loss causation or that the plaintiffs needed to prove price impact as an initial matter to obtain class certification, as the Fifth Circuit's *Halliburton* decision indicated. Instead, Halliburton seemed to be inviting the court to go beyond the question of whether *Oscar* should be overruled and to rule on Halliburton's argument that lack of price impact could be used by defendants to rebut the reliance presumption and only then would plaintiffs be required to affirmatively prove that the market price was in fact distorted, *i.e.* price impact.[39] The Court declined Halliburton's invitation, issuing a narrow decision that did not address how or when the presumption may be rebutted. Thus, the Court left open the possibility that Halliburton could use the "price impact" argument to make an end-run around the holding that loss causation does not have to be proved at the class certification stage.

The Aftermath of *Halliburton*

After the Supreme Court's June 6, 2011 decision, the following sequence of events occurred in relatively short order:

- July 20, 2011 – The Fifth Circuit issued a one page opinion that simply reversed the district court and remanded for further proceedings.[40]
- January 27, 2012 – The District Court issued an order granting class certification.[41]
- February 10, 2012 – Defendants filed a brief requesting permission to appeal the class certification.
- February 22, 2012 – Plaintiff filed its response objecting to another appeal.
- May 22, 2012 – Fifth Circuit Judges Clement and Owen granted Defendants' petition for leave to appeal. Circuit Judge Dennis dissented from the decision to grant leave to appeal.
- June 4, 2012 – District Judge Barbara Lynn stayed the matter pending resolution of this second appeal.
- March 6, 2013 – Setting for oral arguments in the Fifth Circuit.

Halliburton's direct holding will likely only affect plaintiffs in the Fifth Circuit who no longer have to worry about proving a merits-based loss causation element at the class certification stage. It is what *Halliburton* left unsaid, *i.e.* not addressing any other question about *Basic*, its presumption, or how and when it may be rebutted, that remains an open question for all plaintiffs and defendants alike. This is readily apparent from the arguments Halliburton puts forth in its new briefing to the Fifth Circuit regarding rebutting the presumption of reliance at the class certification stage. These new arguments look similar to the merits-based loss causation inquiry albeit with the burden initially on the defendants.

In its brief, Halliburton makes several arguments, one of which details a circuit split over whether the presumption of reliance may be rebutted "at the class-certification stage with evidence that the alleged misrepresentations did not distort the market price."[42] Halliburton

---

[39] *See id.* at 27–28.

[40] *See* Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co., 647 F.3d 533, 534 (5th Cir. 2011).

[41] Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co., No. 3:02CV1152M, 2012 WL 565997, at *1 (N.D. Tex. Jan. 27, 2012).

[42] Defendants' Petition for Permission to Appeal the District Court's January 27, 2012 Order Granting Plaintiff's Motion to Certify Class at 11, Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co., No. 3:02CV1152M, 2012 WL 565997, at *1 (N.D. Tex. Jan. 27, 2012), No. 12-90007 (5th Cir. Feb. 10, 2012), 2012 WL 560072 at *11.

contends that it should be allowed to rebut the reliance presumption in this manner at the class-certification stage and cites to the Fifth Circuit's *Oscar* decision in support, along with the Second Circuit's decision in *In re Salomon Analyst Metromedia Litigation*[43] and the Third Circuit's decision in *In re DVI, Inc. Securities Litigation.*[44] This is the same argument Halliburton proffered during its Supreme Court oral argument.

> *Basic* puts the initial burden on the defendant to show the absence of price impact, showing that the presumed fact does not exist. Once that threshold showing is made, the burden remains on the plaintiff under Rule 301 and Rule 23 to show by a preponderance of the evidence that the market price was in fact, distorted.[45]

In *Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.*,[46] the opinion reversed by the Supreme Court, the Fifth Circuit reiterated its position that in order to prove loss causation, a plaintiff had to prove the alleged misstatements "actually moved the market."[47]

> [T]he causal connection between an allegedly false statement and the price of a stock may be proved either by an increase in stock price immediately following the release of positive information, or by showing negative movement in the stock price after release of the alleged "truth" of the earlier falsehood.[48]

Actual movement of the market, proof of a price increase or proof of a price decrease, which is the Fifth Circuit's standard for proof of loss causation, sounds very similar to proof of price distortion or price impact. In *Halliburton*, the Supreme Court stated that price impact "refers to the effect of a misrepresentation on a stock price,"[49] and Halliburton even stated during its Supreme Court oral argument that the Fifth Circuit meant price impact, not loss causation.[50] The difference may be an initial burden on the defendants to prove absence of price impact, but the end result is the same, a plaintiff will have to prove a merits-based inquiry (loss causation or price impact) at the class certification stage. Even Halliburton conceded that at least one circuit has held that "price impact is a 'merits' issue that cannot be considered at the class certification stage."[51]

---

[43] 544 F.3d 474 (2d Cir. 2008).

[44] 639 F.3d 623, 638 (3d Cir. 2011); *see* Defendants' Petition for Permission to Appeal the District Court's January 27, 2012 Order Granting Plaintiff's Motion to Certify Class at 11–12, Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co., No. 3:02CV1152M, 2012 WL 565997, at *1 (N.D. Tex. Jan. 27, 2012), No. 12-90007 (5th Cir. Feb. 10, 2012), 2012 WL 560072 at *11–12.

[45] Transcript of Oral Argument at 28, Erica P. John Fund, Inc. v. Halliburton Co., 131 S. Ct. 2179 (2011) (No. 09-1403).

[46] 597 F.3d 330 (5th Cir. 2010).

[47] 597 F.3d at 335.

[48] *Id*.

[49] *See* Erica P. John Fund, Inc. v. Halliburton Co., 131 S. Ct. 2179, 2187 (2011).

[50] Transcript of Oral Argument at 27, Erica P. John Fund, Inc. v. Halliburton Co., 131 S. Ct. 2179 (2011) (No. 09-1403).

[51] Defendants' Petition for Permission to Appeal the District Court's January 27, 2012 Order Granting Plaintiff's Motion to Certify Class at 12, Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co., No. 3:02CV1152M, 2012 WL 565997, at *1 (N.D. Tex. Jan. 27, 2012), No. 12-90007 (5th Cir. Feb. 10, 2012), 2012 WL 560072 at *12 (citing Schleicher v. Wendt, 618 F.3d 679, 685 (7th Cir. 2010)).

In the pending *Halliburton* appeal in the Fifth Circuit, the key question is whether the defendant can rebut the presumption of reliance at the class certification stage by showing a lack of price impact. While the Fifth Circuit has yet to weigh in on this issue, the U.S. Supreme Court recently addressed the analogous issue of whether the defendant can defeat class certification based on lack of materiality. In *Amgen Inc. v. Connecticut Retirement Plans and Trust Funds*,[52] decided on February 27, 2013 in a six to three decision, the Supreme Court held that while plaintiffs in a securities fraud class action must prove materiality to prevail on the merits, "such proof is not a prerequisite to class certification."[53] Like Halliburton, Amgen conceded an efficient market and did not dispute that all of the Rule 23(a) requirements for class certification were met.[54] Therefore, like the *Halliburton* case, the sole issue was Rule 23(b)(3) and whether "questions of law or fact common to class members predominate over any questions affecting only individual members."[55] Amgen contended that certification had to be denied unless the plaintiff, Connecticut Retirement, proved "materiality, for immaterial misrepresentations or omissions, by definition, would have no impact on Amgen's stock price in an efficient market."[56] Further, Amgen argued the District Court had erred when it failed to consider its rebuttal evidence offered in opposition to the plaintiff's class certification motion, principally that the alleged misrepresentations and omissions were immaterial.[57] The Supreme Court granted certiorari to resolve conflict on this issue among the Courts of Appeals, the same conflict Halliburton pointed to in its brief to the Fifth Circuit.[58]

The Supreme Court held that proof of this materiality was not appropriate at the class-certification stage. "Amgen's argument, if embraced, would necessitate a mini-trial on the issue of materiality at the class-certification stage."[59] "Proof of that sort is a matter for trial (and presumably also for a summary-judgment motion under Federal Rule of Civil Procedure 56)."[60] The Supreme Court succinctly stated:

> Rule 23(b)(3) requires a showing that *questions* common to the class predominate, not that those questions will be answered, on the merits, in favor of the class. Because materiality is judged according to an objective standard, the materiality of Amgen's alleged misrepresentations and omissions is a question common to all members of the class Connecticut Retirement would represent. The alleged misrepresentations and omissions, whether material or immaterial, would be so equally for all investors composing the class. As vital, the plaintiff class's inability to prove materiality would not result in individual questions predominating. Instead, a failure of proof on the issue of materiality would end the case, given that materiality is an essential element of the class members' securities-fraud claims. As to materiality, therefore, the class is entirely cohesive: It will

---

[52] 133 S. Ct. 1184 (2013).

[53] *Amgen,* 133 S. Ct. at 1191.

[54] *Id.* at 1190–91.

[55] *Id.* at 1191.

[56] *Id.*

[57] *Id.* at 1194.

[58] *Id.*

[59] *Id.* at 1201.

[60] *Id.* at 1204 (citations omitted) (quotations omitted).

> prevail or fail in unison. In no event will the individual circumstances of particular class members bear on the inquiry.[61]

The *Amgen* decision seems to weaken the basis for Halliburton's pending appeal. Whether phrased as proof of materiality by the plaintiff or rebuttal evidence by the defense of lack of price impact, it may be difficult for Halliburton to overcome the argument that class members will rise and fall together. Like materiality in *Amgen*, price impact in *Halliburton* is a merits issue that is common to all members of the class. Arguably this makes price impact an inappropriate inquiry for class certification where the class will "prevail or fail in unison."[62]

[61] *Id.* at 1191 (emphasis in original).

[62] *Id.*

BANKRUPTCY APPEALS

Ben L. Mesches*

TABLE OF CONTENTS

* Ben L. Mesches is a partner in the appellate practice group at Haynes and Boone, LLP in Dallas. Ben is a board-certified appellate lawyer with diverse experience in complex business, energy, and bankruptcy disputes in state and federal appellate courts. He also litigates in the trial court, playing a key role on successful trial teams, developing legal strategy from the outset of litigation, making and responding to dispositive motions, preparing and arguing the jury charge, and crafting post-trial briefing.

I. Introduction

An appeal of a bankruptcy court order or judgment involves unique procedural and jurisdictional considerations. Bankruptcy appeals are different from an ordinary federal court appeal because of the unusually quick time frame for perfecting and briefing the appeal and the likelihood that such an appeal may be subject to substantive[1] review by two appellate courts (the district court or Bankruptcy Appellate Panel[2] and the court of appeals). In approaching a bankruptcy appeal, practitioners must consider a bankruptcy-specific jurisdictional statute, a liberalized view of finality, and a different set of rules depending on whether the appeal is to the district court or the court of appeals. This paper sets forth a nuts-and-bolts approach for handling a bankruptcy appeal and considers some of the more complex jurisdictional issues.

The dramatic changes to the Bankruptcy Code in 2005 included an expansion of the court of appeals' jurisdiction over bankruptcy court decisions. Congress gave the lower courts power to certify bankruptcy court decisions (whether final or interlocutory) for direct appeal to the court of appeals. One of the principal reasons for this change was concern – by both advocates and members of Congress – that bankruptcy appeals frequently "languished" in the district court and that the circuit courts were not deciding a number of critical bankruptcy issues – and was therefore not establishing precedent in these cases. This paper provides a comprehensive overview of this new direct appeal provision, including the standard for obtaining certification, the mechanics of taking an appeal directly to the court of appeals, and discusses the first set of decisions to construe this new provision. Appellate lawyers are well-suited to providing guidance in determining whether to seek a direct appeal and persuading both the lower court and the court of appeals to permit a direct appeal to go forward.

This paper provides a guide to the rules governing an appeal to the district court and the court of appeals. The most important issue with respect to these relatively straightforward rules is that the deadlines in bankruptcy appeals are much shorter than in ordinary federal court appeals. This paper also addresses two additional issues – the relaxed standard for finality, providing a broader range of orders subject to appeals, and the jurisdictional statute. Although bankruptcy appeals frequently involve technical and specialized issues (much like intellectual property cases), an appellate lawyer's involvement in a bankruptcy appeal can nevertheless be quite valuable – from providing guidance on timing and procedural requirements to strategic assessments regarding direct appeals, interlocutory appeals, and finality.

---

[1] However, bankruptcy appeals "often languish in the district courts until they become moot" making dual appellate review illusory in some instances. *See* Testimony of Hugh Ray, Former Chair of Business Bankruptcy Committee of the Business Law Section of the American Bar Association, 1999 WL 1079983 (Nov. 2, 1999).

[2] Bankruptcy court orders may be appealed in the first instance to the district court or the Bankruptcy Appellate Panel. In the Fifth Circuit, district courts decide bankruptcy appeals. Only the First, Sixth, Eighth, Ninth, and Tenth Circuits have Bankruptcy Appellate Panels, and, other than in the Ninth Circuit, Bankruptcy Appellate Panels are rarely used. *Judicial Business of the United States Courts*, at Table B-10 (stating that, of the 989 bankruptcy appeals decided by a Bankruptcy Appellate Panel in 2004, 645 of those appeals took place in the Ninth Circuit). "In the 12-month period that ended March 31, 2004, district judges nationwide received 2,838 bankruptcy appeals and [Bankruptcy Appellate Panels] received 1,006." David R. Weinstein, *What's a BAP and Why Did I Go There?* at 4, Section of Business Law, American Bar Association (Aug. 8, 2005). Even when a Bankruptcy Appellate Panel is in place, a party may elect to appeal to the district court instead. 28 U.S.C. § 158(c)(1) (2006); FED R. BANKR. P. 8001(e). As a result, the focus of this paper is on appeals to the district court.

II. Jurisdictional Statutes

A. Jurisdiction under section 158(a)

The jurisdictional basis for an appeal of a bankruptcy court order is contained in 28 U.S.C. § 158(a). Under section 158(a), the district court has jurisdiction over appeals of final orders, interlocutory orders altering the time in which the debtor has the exclusive right to propose a plan of reorganization, and with leave of the district court, other interlocutory orders.[3]

The court of appeals has jurisdiction over all appeals of final judgments entered under section 158(a) and (b).[4] Before the 2005 amendments to the jurisdictional statute, a party wishing to appeal a non-final district court order was forced to rely on 28 U.S.C. § 1292(b) to appeal such an order to the court of appeals.[5]

B. The Direct-Appeal Provision

In 2005, as a part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"), Congress amended section 158(d) (the jurisdictional statute for bankruptcy appeals brought in the court of appeals) to provide for a *discretionary* direct appeal from the bankruptcy court to the Circuit Court of Appeals. This new provision took effect 180 days after enactment (October 17, 2005) and applies only to bankruptcy cases filed on or after October 17, 2005.[6]

One of the principal reasons for this change was "widespread unhappiness at the paucity of settled bankruptcy-law precedent."[7] Congress also enacted the direct appeal provision because (i) of "the time and cost factors attendant to the present appellate system," and (ii) "decisions rendered by a district court as well as a bankruptcy appellate panel are generally not binding and lack stare decisis value."[8]

Under 28 U.S.C. § 158(d)(2)(A), the Circuit Court has jurisdiction over appeals "described in the first sentence of subsection (a) if the bankruptcy court, the district court, or the bankruptcy appellate panel" *or* the parties jointly certify that (i) the judgment "involves a question of law as to which there is no controlling decision of the court of appeals for the

---

[3] 28 U.S.C. § 158(a)(1)-(3) (2006); FED. R. BANKR. P. 8001(a) (describing appeals under section 158(a)(1) & (2) as appeals "of right"); FED. R. BANKR. P. 8001(b) (setting forth the procedure for taking an appeal from an interlocutory order under section 158(a)(3)).

[4] 28 U.S.C. § 158(d).

[5] *See* 28 U.S.C. § 1292(b) (2006).

[6] Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 1501(a), 119 Stat. 23 (codified as amended in scattered sections of 11 U.S.C.); *In re* McKinney, 457 F.3d 623, 624 (7th Cir. 2006) (dismissing attempted direct appeal under BAPCPA because the amendments do not apply "to bankruptcy proceedings filed before the effective date of the provision, which was October 17, 2005"); *In re* Blumeyer, No. 4:06CV1681 CDP, 2007 U.S. Dist. LEXIS 5037, at *4 (Bankr. E.D. Mo. Jan. 24, 2007) (same); *In re* Berman, 344 B.R. 612, 615 (B.A.P. 9th Cir. 2006) (same).

[7] Weber v. U.S. Tr., 484 F.3d 154, 158 (2d Cir. 2007).

[8] H.R. REP. NO. 109-31, pt. 1, at 148 (2005); *see also Weber*, 484 F.3d at 158–59 (observing that direct-appeal provision designed to resolve legal—not fact-intensive—questions and that "Congress hoped that [this provision] would permit us to resolve controlling legal questions expeditiously and might foster the development of coherent bankruptcy-law precedent").

circuit or of the Supreme Court of the United States, or involves a matter of public importance," (ii) the judgment "involves a question of law requiring resolution of conflicting decisions," or (iii) "an immediate appeal [would] ... materially advance the progress of the case or proceeding in which the appeal is taken."[9] Only one of the three certification requirements must be met for the lower court to certify a direct appeal to the court of appeals.

The bankruptcy court, district court, or Bankruptcy Appellate Panel "shall" make the certification if (i) on its own or on a party's motion the court determines that *any* of the above circumstances are satisfied, or (ii) the court receives a request by a majority of appellants and majority of appellees to make the certification.[10] Thus, the lower courts have no discretion to decline to certify an appeal if one of the certification requirements is satisfied or a majority of appellants and appellees agree that certification is appropriate.

1. *Procedural Rules*

A party seeking certification under this provision must file such a motion within sixty days of the judgment.[11] The notice of appeal, however, is due within fourteen days—not sixty days.[12] An appeal under section 158(d) "does not stay any proceeding of the bankruptcy court, the district court, or the bankruptcy appellate panel from which the appeal is taken, unless the respective [court] . . . issues a stay of such proceeding pending the appeal."[13]

Review at the circuit court is discretionary.[14] To obtain direct appellate review, the appellant must file a petition for permission to appeal in the court of appeals under Federal Rule of Appellate Procedure 5.[15] That petition must—in addition to complying with Rule 5—be filed "no later than 30 days after a certification has become effective as provided in subdivision (f)(1)."[16] Section 158(d)(2) does not create any standards applicable to the appellate court's decision to dispose of the petition for permission to appeal.

Before the recent amendments, the court of appeals could not review an interlocutory bankruptcy court order absent a section 1292(b) certification from the district court.[17] Congress enacted the direct appeal provision because (i) of "the time and cost factors attendant to the present appellate system," and (ii) "decisions rendered by a district court as well as a bankruptcy appellate panel are generally not binding and lack stare decisis value."[18]

---

[9] 28 U.S.C. § 158(d)(2)(A)(i)-(iii) (2006).

[10] 28 U.S.C. § 158(d)(2)(B).

[11] 28 U.S.C. § 158(d)(2)(E).

[12] *See* FED. R. BANKR. P. 8002; *see In re* Virissimo, 332 B.R. 208, 208–09 n.1 (Bankr. D. Nev. 2005) (certification without perfection of appeal does not allow a party to obtain direct-appeal review by the circuit court); FED. R. BANKR. P. 8001 advisory committee's note (2008 Amendments, Subdivision (f)) (noting that a notice of appeal is required in direct appeals of bankruptcy court orders).

[13] 28 U.S.C. § 158(d)(2)(D).

[14] 28 U.S.C. § 158(d)(2)(A).

[15] FED. R. BANKR. P. 8001(f)(5).

[16] *Id*.

[17] *See* Conn. Nat'l Bank v. Germain, 503 U.S. 249, 252–54 (1992); *In re* Tex. Extrusion Corp., 844 F.2d 1142, 1156 n.18 (5th Cir. 1988).

[18] H.R. REP. NO. 109-31, pt. 1, at 148 (2005); for a comprehensive discussion of the legislative history and purpose of the direct appeal provision, *see* Hon. Dennis Montali, *Revised Bankruptcy Appellate Procedures under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005* (presented to the Section of Business Law, American Bar Association Aug. 8, 2005).

Additional procedural rules have now been adopted that address the unique procedural issues that stem from appeal of a bankruptcy court order to the district court, on the one hand, and seeking to bypass district court review, on the other.

- Under Rule 8001(f)(1), certification by the bankruptcy court is not effective until a notice of appeal is filed.[19]

- Rule 8001(f)(2) addresses where the certification is to be made: If the case is pending in the bankruptcy court, only the bankruptcy court can certify the case for direct appeal. Likewise, if the case is pending in the district court, only the district court can certify the case for direct appeal.[20] This rule "adopts a bright-line test for identifying the court in which the matter is pending."[21]

- Rule 8001(f)(2) outlines the procedure for a joint certification by the appellants and appellees, urging parties to use the official form.[22]

- Rule 8001(f)(3) sets forth the requirements, in terms of form, contents, service, and filing, for a party's certification request and any response to that request.[23]

- Rule 8001(f)(4) addresses the court's power to certify on its "own initiative."[24]

- Rule 8003(d) "solve[s] the jurisdictional problem that could otherwise ensue when a district court or bankruptcy appellate panel has not granted leave to appeal under 28 U.S.C. § 158(a)(3)."[25] Under the rule, if the court of appeals authorizes a direct appeal, that authorization is "deemed to satisfy the requirement for leave to appeal."[26]

2. *Guidance from the Circuit Courts on the Application of the Direct-Appeal Provision*

Although many circuit courts have considered appeals under 28 U.S.C. § 158(d)(2), the Second Circuit has given the most detailed treatment of the statute and the standards courts should apply in determining whether to grant leave to permit a direct appeal.

In *Weber v. United States Trustee*,[27] the Second Circuit was presented with a case involving New York's homestead exemption the bankruptcy court had certified for direct appeal. The Second Circuit set forth a comprehensive analysis of the purpose and application of section 158(d)(2) and declined to accept the appeal. The Court focused on three issues—the text of the statute, its purpose, and what it termed "jurisprudential considerations."[28]

---

[19] FED. R. BANKR. P. 8001(f)(1); FED. R. BANKR. P. 8001 advisory committee's note (2008 Amendments, Subdivision (f)).

[20] FED. R. BANKR. P. 8001(f)(2).

[21] FED. R. BANKR. P. 8001 advisory committee's note (2008 Amendments, Subdivision (f)).

[22] FED. R. BANKR. P. 8001(f)(2)(B).

[23] FED. R. BANKR. P. 8001(f)(3).

[24] FED. R. BANKR. P. 8001(f)(4).

[25] FED. R. BANKR. P. 8003(d); FED. R. BANKR. P. 8003 advisory committee's note (2008 Amendments).

[26] FED. R. BANKR. P. 8003(d).

[27] 484 F.3d 154 (2d Cir. 2007).

[28] *Id.* at 158.

The Court began by noting that "this court 'shall have jurisdiction of appeals' from a bankruptcy court if the bankruptcy court certifies that either '(i) the judgment, order, or decree involves a question of law as to which there is no controlling decision . . . or involves a matter of public importance; (ii) the judgment, order, or decree involves a question of law requiring resolution of conflicting decisions; or (iii) an immediate appeal from the judgment, order, or decree may materially advance the progress of the case.'"[29]

The *Weber* Court then turned to the legislative history of the direct-appeal provisions and observed that the purpose of the statute is to (i) "facilitate our provision of guidance on pure questions of law," (ii) stem the "widespread unhappiness at the paucity of settled bankruptcy-law precedent," and (iii) allow appeals "where a judgment of [the appellate] court would 'materially advance the progress of the case.'"[30] On this final point, the Court emphasized that an appeal might materially advance the case in the following circumstances:

> [W]here a bankruptcy court has made a ruling which, if correct, will essentially determine the result of future litigation, the parties adversely affected by the ruling might very well fold up their tents if convinced that the ruling has the approval of the court of appeals, but will not give up until that becomes clear. Where that ruling is manifestly correct or manifestly erroneous, the parties would profit from its immediate review in this court.[31]

In determining the purpose of the direct-appeal provision, the Second Circuit also compared this statute to other discretionary interlocutory-appeal provisions addressing appeals from class-action certification decisions and interlocutory orders on controlling legal questions.[32]

The *Weber* Court thus concluded that the direct-appeal provision "would permit us to resolve controlling legal questions expeditiously and might foster the development of coherent bankruptcy-law precedent."[33]

The Court also emphasized that there are countervailing factors in determining whether to accept a direct appeal. It noted, for example, that allowing issues to percolate in the lower courts would enhance the circuit court's ultimate resolution of important legal questions:

> In many cases involving unsettled areas of bankruptcy law, review by the district court would be most helpful. Courts of appeals benefit immensely from reviewing the efforts of the district court to resolve such questions. Permitting direct appeal too readily might impede the development of a coherent body of bankruptcy case-law.[34]

The Court also recognized that "in most cases, even without certification, the parties will have an opportunity to appeal both to the district court and to this court before the termination of the entire bankruptcy proceeding, thereby satisfying many of the objectives here that also

---

[29] *Id*. at 157 (quoting 28 U.S.C. § 158(d)(2)(A)(i)-(iii)).

[30] *Id*. at 158.

[31] *Id*.

[32] Weber v. U.S. Tr., 484 F.3d 154, 159–60 (2d Cir. 2007) (synthesizing the standards under 28 U.S.C. § 1292(b) and Federal Rule of Civil Procedure 23(f)).

[33] *Id*. at 159.

[34] *Id*. at 160.

underlie" other discretionary-appeal provisions.[35]

The Court concluded with the following guidance on when it would be most likely to accept a direct appeal or opt not to accept the case on direct appeal because there was no conflict in the lower courts and an immediate review would not "lead to a more rapid resolution of the case:"

> We will be most likely to exercise our discretion to permit a direct appeal where there is uncertainty in the bankruptcy courts (either due to the absence of a controlling legal decision or because conflicting decisions have created confusion) or where we find it patently obvious that the bankruptcy court's decision is either manifestly correct or incorrect, as in such cases we benefit less from the case's prior consideration in the district court and we are more likely to render a decision expeditiously, thereby advancing the progress of the case. On the other hand, we will be reluctant to accept cases for direct appeal when we think that percolation through the district court would cast more light on the issue and facilitate a wise and well-informed decision.[36]

3. *Decisions Under the Direct-Appeal Provision*

This section catalogs decisions from across the country addressing the direct-appeal provision and explores the circumstances in which direct appeals have been permitted and those in which courts declined to allow a direct appeal to go forward.

C. Cases Certified for Direct Appeal

Second Circuit

***In re Elmendorf*:**[37] The bankruptcy court certified its order striking—but not dismissing—debtors' Chapter 7 and 13 bankruptcy cases based upon their failure to obtain credit counseling before seeking bankruptcy protection, as required by BACPA. Because the bankruptcy court's decision was "at odds" with the results reached in other bankruptcy courts within the Second Circuit, the bankruptcy court "determined that it is appropriate to certify these questions to the Second Circuit Court of Appeals pursuant to 28 U.S.C. § 158(d)(2)(A)(ii) and Interim Fed. R. Bankr. R. 8001(f)(4)."[38] The bankruptcy trustee, however, declined the invitation to appeal the bankruptcy court's refusal to dismiss directly to the Second Circuit and instead sought review from the district court in the first instance.[39]

---

[35] *Id*. at 161.

[36] *Id.*

[37] 345 B.R. 486 (Bankr. S.D.N.Y. 2006).

[38] 345 B.R. at 505.

[39] Adams v. Finlay, No. 06 Civ. 6039 (CLB), 2006 U.S. Dist. LEXIS 81591, at *3 (S.D.N.Y. Nov. 3, 2006) ("The Bankruptcy Court certified three related questions directly to the Court of Appeals for the Second Circuit, but the Trustee did not pursue the certification, seeking instead appellate review in the first instance in the District Court.") (appeal dismissed for lack of standing).

Fourth Circuit

***Tidewater Finance Co. v. Kenney*:**[40] The Fourth Circuit granted a petition for permission to appeal because "a direct appeal . . . presents, among other things, a question of law as to which there is no controlling decision of this Court or of the United States Supreme Court and which requires resolution of conflicting decisions among bankruptcy courts in various circuits."

Fifth Circuit

***Compton v. Anderson* (*In re MPF Holdings US LLC*):**[41] This case addressed whether a confirmed plan of reorganization sufficiently retained preference claims to be pursued on a post-confirmation basis.

***CRG Partners Group, L.L.C. v. Neary* (*In re Pilgrim's Pride Corp.*):**[42] The question in this case is whether *Perdue v. Kenny A. ex rel Winn*[43] applied to prohibit fee enhancements for professionals employed under section 330 of the Bankruptcy Code.

***Spicer v. Laguna Madre Oil & Gas II, L.L.C.* (*In re Tex. Wyo. Drilling, Inc.*):**[44] This case further addressed the *United Operating* standard for a debtor to retain post-confirmation claims.

***Mesdag v. Nancy Sue Davis Trust* (*In re Davis Offshore, L.P.*):**[45] This case affirmed a bankruptcy court's decision rejecting post-confirmation fraud claims because release and exculpation provisions of the plan barred such claims.

***Bank of New York Trust Co. v. Official Unsecured Creditors' Committee* (*In re Pacific Lumber Co.*):**[46] The Fifth Circuit initially noted that Congress enacted section 158(d)(2) for two narrow purposes—(i) "to expedite appeals in significant cases" and (ii) "to generate binding appellate precedent in bankruptcy, whose caselaw has been plagued by indeterminacy."[47] *Pacific Lumber* was a massive Chapter 11 case that was of "prominence . . . to the citizens of California, of Humboldt County, and of the town of Scotia and by the plan's effect on 'one of the nation's most ecologically diverse forests.'"[48] In addition to the public interest at stake, the Court faced a unique set of circumstances that also warranted an immediate appeal. First, there was a substantial risk that an appeal of the bankruptcy court's unstayed confirmation order could be rendered moot if the ordinary appellate process were to run its course.[49] Second, the case presented a novel question of bankruptcy law involving a bankruptcy court's authority to cramdown secured debt.[50]

---

[40] 531 F.3d 312, 315 (4th Cir. 2008).

[41] 701 F.3d 449 (5th Cir. 2012).

[42] 690 F.3d 650 (5th Cir. 2012).

[43] 559 U.S. 542 (2010).

[44] 647 F.3d 547 (5th Cir. 2011).

[45] 644 F.3d 259 (5th Cir. 2011).

[46] 584 F.3d 229 (5th Cir. 2009).

[47] *Id.* at 241–42.

[48] *Id.* at 242.

[49] *Id.*

[50] *Id.* at 242–43.

***Crosby v. Orthalliance* (*In re OCA, Inc.*)**:[51] "Since this is an appeal from an interlocutory order from the bankruptcy court regarding a question of law on which there is no controlling precedent, we will treat this appeal essentially as we treat certified questions from district courts."

***Drive Financial Services, L.P. v. Jordan*:**[52] The Fifth Circuit allowed direct review of another "hanging paragraph" issue and resolved the legal question of whether BAPCPA's "hanging paragraph" superseded the United State's Supreme Court's cramdown decision in *Till v. SCS Credit Corporation*.[53]

***Ad Hoc Group of Timber Noteholders v. Pacific Lumber Co.* (*In re Scotia Pacific Co., LLC*):**[54] The appellee asked the Fifth Circuit to revisit the motion panel's decision to grant direct-appeal review because the case was pending in the bankruptcy court when the district court certified the case for direct appeal.[55] The court agreed that the bankruptcy court—not the district court—should have certified the case for direct appeal because the appeal had not yet been docketed in the district court.[56] Nevertheless, the Fifth Circuit concluded that "this procedural glitch" was not a jurisdictional defect and, therefore, did not deprive the court of jurisdiction: "[T]his error is technical in nature, does not affect the substantial rights of the parties, and prompts us to exercise our discretion in favor of proceeding to the merits of this appeal."[57]

Ninth Circuit

Blausey v. U.S. Trustee:[58] The Ninth Circuit concluded that the issue presented affected every Chapter 7 bankruptcy case, raised a question of law, and lacked clear precedent in determining that direct appeal was appropriate.

***General Electric Capital Corp. v. Future Media Productions Inc.*:**[59] The Ninth Circuit resolved an unsettled legal issue in the Circuit and ordered the lower courts to apply the majority rule adopted by the Fifth and Seventh Circuits.

***In re Virissimo*:**[60] The bankruptcy court, again on its own, certified the following question to the Ninth Circuit: Do the 2005 revisions to the Bankruptcy Code, "which limit the amount of the homestead available to those who have owned their homestead less than 1215 days," apply to Nevada debtors?

> This court fully recognizes and appreciates the work done by, and expertise of, the bankruptcy appellate panel and the district court in hearing and deciding appeals from the bankruptcy court. This court is also fully

[51] 552 F.3d 413, 418 (5th Cir. 2008).

[52] 521 F.3d 343, 346–48 (5th Cir. 2008).

[53] 541 U.S. 465 (2004).

[54] 508 F.3d 214 (5th Cir. 2007).

[55] *Id.* at 218–19.

[56] *Id.* at 219.

[57] *Id.* at 220.

[58] 552 F.3d 1124, 1131–32 (9th Cir. 2009).

[59] 536 F.3d 969, 971, 973–74 (9th Cir. 2008).

[60] 332 B.R. 208, 209 (Bankr. D. Nev. 2005).

> cognizant of the tremendous workload of the Ninth Circuit Court of Appeals. However, the issue presented in this case is one which will recur in Nevada as well as other districts in the Ninth Circuit and will impact the administration of bankruptcy estates until the issue is ultimately decided. As this involves the statutory construction of a hotly contested provision of BACPA and is a matter of first impression, there is no question that the Court of Appeals will ultimately be required to determine the question. Hence not merely one, but all three, of the criteria specified in § 158 exist and justify an immediate appeal in this case.[61]

Tenth Circuit

***Affordable Bail Bonds, Inc. v. Sandoval* (*In re Sandoval*):**[62] The Tenth Circuit granted a direct appeal to resolve "a question of first impression in this circuit."

Eleventh Circuit

***Daimler Chrysler Financial Services Americas LLC v. Barrett (In re Barrett)*:**[63] The Eleventh Circuit agreed to accept a direct appeal on the issue of whether a claim that comes under the "hanging paragraph" of section 1325(a)(9) of the Bankruptcy Code is an allowed secured claim, permitting payment in full, plus post-petition interest to the creditor.

D. Decisions Declining to Certify for Direct Appeal

First Circuit

***Nickless v. Kessler* (*In re Berman*):**[64] The bankruptcy court denied a request to certify because "the Court does not find that any of the circumstances enumerated in clause (i), (ii), or (iii) exist here."

***In re Marrama*:**[65] The bankruptcy court refused to certify its order dismissing a debtor's Chapter 13 case because he had an already-pending "Chapter 7 case in which he was denied his discharge." The bankruptcy court analyzed the section 158(d)(2) factors as follows:

> I granted the motion to dismiss because I determined that the Debtor could not meet the eligibility requirements. I did not address what constitutes a contingent debt because none of the debts which I used in my calculation were debts that the Debtor described as contingent. It appears that the Debtor's issue with the decision is that I could not look to the amounts of the outstanding nondischargeable debts set forth in his pending Chapter 7. While there is no controlling case law in this circuit, the case law above reflects that there is no significant dispute regarding the applicable standard for looking at pending cases. This is not an issue of significant proportion or one that is certain to arise repeatedly. Therefore, I cannot conclude that the Debtor has met the first criteria. As for the second, I am not convinced that the purpose behind certification is to enable a litigant to obtain a binding

---

[61] *Id*.

[62] 541 F.3d 997, 998–99 & n.2 (10th Cir. 2008).

[63] 543 F.3d 1239, 1241 (11th Cir. 2008).

[64] No. 04-45436, 2007 Bankr. LEXIS 65, at *5 (Bankr. D. Mass. Jan. 5, 2007).

[65] 345 B.R. 458, 460 (Bankr. D. Mass. 2006).

> decision from a circuit court on every adverse ruling from this court. As for the third prong, I cannot determine that a ruling from the First Circuit, as opposed to an appeal to the BAP or the district court would materially advance this appeal. Accordingly, I will not certify the matter to the First Circuit.[66]

Second Circuit

***Weber v. United States Trustee*:**[67] Despite certification by the bankruptcy court, the Second Circuit declined to exercise its discretionary jurisdiction to decide whether an increase in the New York homestead exemption should apply retroactively because the Court did not "perceive a conflict of such a nature that creates uncertainty in the bankruptcy courts."[68] This decision contains an extensive discussion of the legislative history and purpose of the direct-appeal provision and provided the guidance quoted at the end of Part III, *supra*, concerning when the Second Circuit would be most likely to accept a direct appeal.

Third Circuit

***In re Fields*:**[69] The bankruptcy court declined to certify a question related to the violation of the automatic stay provision because:

> The question of law involved in this case is directly answered by the statutory provisions cited above. I am not aware of conflicting decisions regarding the termination of the automatic stay by operation of law following abandonment of property by the trustee. The material advancement of the progress of the case is not implicated.[70]

***Simon & Schuster, Inc. v. Advanced Marketing Services, Inc.*:**[71] This decision explores an issue that arises when the underlying order is interlocutory in nature and the only way to effectively prosecute an appeal is to request certification under section 158(d)(2) and file a motion for leave to appeal under section 158(a)(3) and Rule 8003. That is precisely what Simon & Shuster did here in seeking review of an order denying its motion for a temporary restraining order.[72] The motion for leave to appeal was transmitted to the district court for disposition. The request for certification remained pending in the bankruptcy court.[73] The bankruptcy court ultimately deferred consideration of the request for direct appeal certification so that the district court could decide whether (i) an interlocutory appeal should be permitted under section 158(a)(3), and (ii) direct appeal was available.[74]

---

[66] *Id.* at 474.

[67] 484 F.3d 154 (2d Cir. 2007).

[68] *Id*. at 161 (observing that "all three of the courts within this circuit to have considered the question have held that New York's homestead exemption applies retroactively").

[69] No. 05-60595/JHW, 2006 Bankr. LEXIS 4090 (Bankr. D. N.J. Oct. 24, 2006).

[70] *Id.* at *7–8.

[71] 360 B.R. 429 (Bankr. D. Del. 2007).

[72] *Id*. at 431 (noting the simultaneous filing of a notice of appeal, motion for leave to appeal, and request for certification).

[73] *Id*. at 432 (stating that under Interim Rule 8001(f)(2), a matter remains pending in the bankruptcy until the district court grants leave to appeal under section 158(a)(3)).

[74] *Id*. at 434–35.

The *Simon & Schuster* Court reached this conclusion apparently based upon its assessment that standards for both a section 158(a)(3) motion and section 158(d)(2) certification are "*virtually identical*."[75] That is, there is no reason for the bankruptcy court to step on the district court's toes and decide the certification question before the district court has that opportunity (after first granting leave to appeal).[76]

Fifth Circuit

***Stansbury v. Holloway* (*In re Holloway*):**[77] The Fifth Circuit initially dismissed this appeal because the appellant did not obtain a certification from either the bankruptcy court or district court authorizing a direct appeal to the Fifth Circuit. The parties asked for and procured a certification from the bankruptcy court after the appeal was dismissed. The Fifth Circuit dismissed yet again because the requirement to seek certification within sixty days of the order under section 158(d)(2)(E) was held to be jurisdictional, and the parties did not ask for certification from the bankruptcy court within that window.[78]

***Gomez v. Kamper Investments, L.L.C.,* (*In re Gomez*):**[79] In an opinion providing a comprehensive overview of appellate review options in the context of an interlocutory order, the Court addressed whether a district court's decision to remand the case to the bankruptcy court for further proceedings on whether a foreclosure sale could be avoided under the Bankruptcy Code. After the decision on remand refusing to avoid the sale, the bankruptcy judge suggested that the parties pursue a direct appeal to the Fifth Circuit to more efficiently resolve the case.[80] The appellants never filed the required certification for direct appeal either in the bankruptcy court or district court, although they did file a notice of appeal to the Fifth Circuit. The Fifth Circuit dismissed for want of jurisdiction because of the appellants' failure to file a certification request—a statutory requirement under section 158(d)(2).[81]

Sixth Circuit

***In re Davis*:**[82] The Sixth Circuit declined to accept a certified appeal regarding whether—in the Chapter 13 context—a vehicle ownership expense is an allowable expense if the debtor has no loan or lease payment. The court noted that "material advancement" was not a factor and that the "extent of the conflict is unclear."[83] Therefore, the court declined to "exercise [its] discretion" to decide the appeal.[84] The court also noted at least two procedural infirmities: (i) the failure to attach the bankruptcy court's order to the petition as required under Federal Rule of Appellate Procedure 5, and (ii) the failure to file a notice of appeal to the district court or bankruptcy appellate panel as required by Interim Rule 8001(f)(1).[85]

---

[75] *Id*. at 434 (emphasis in original); *id*. at 434 (requiring the bankruptcy court "to perform the same analysis generally reserved for the district court").

[76] Simon & Schuster, Inc. v. Advanced Mktg. Servs. Inc., 360 B.R. 429, 434 (Bankr. D. Del. 2007) (asserting that ruling otherwise "is contrary to the hierarchy of the court system").

[77] 425 Fed. App'x 354 (5th Cir. 2011).

[78] *Id.* at 357–58.

[79] 404 Fed. App'x 850 (5th Cir. 2010).

[80] *Id.* at 851–52.

[81] *Id.* at 855.

[82] 512 F.3d 856, 857 (6th Cir. 2008).

[83] *Id.* at 858.

[84] *Id.*

[85] *Id.* at 857.

Eleventh Circuit

***In re Waczewski*:**[86] Although concluding that section 158(d)(2) did not apply, the court nevertheless addressed the availability of direct appeal and concluded that it would not certify its order for direct appeal, noting "a party seeking a direct appeal certainly must show something more than that a direct appeal would expedite the resolution of the appellate issues."

****

Five years ago Congress adopted an important provision that allows parties to seek immediate appellate review of bankruptcy court decisions in the circuit courts. The purpose of this provision was to expedite appeals when a direct appeal would materially advance the progress of the case and to generate binding appellate precedent in bankruptcy—a longstanding problem that resulted from the dual appellate review process applicable in bankruptcy. Although many of the circuits have utilized this procedure to resolve legal questions (*e.g.*, statutory construction issues and conflicts in the case law), few courts have developed a comprehensive approach to analyzing whether a direct appeal is appropriate. As the case law continues to develop, courts and practitioners should continue to assess whether direct appeals are employed for the narrow purposes intended by Congress or whether courts and parties broaden the use of such appeals to address discretionary and fact-intensive issues.

III. Finality

Determining finality is a threshold question and is often overlooked in the frenzy following an adverse ruling by the bankruptcy court. Frequently, there is a little time to engage in a comprehensive analysis of finality after a decision has been issued (remember, you only have fourteen days to perfect the appeal). This is an area where an appellate lawyer can be of great assistance to the bankruptcy team. The initial decision will be whether to file a notice of appeal or—if the order is merely interlocutory—to file a motion for leave to appeal.[87]

Finality in the bankruptcy context involves a different inquiry than in an ordinary federal appeal.[88] The Fifth Circuit has explained the "unique" considerations at play in a bankruptcy appeal warranting a more flexible view of finality:

> [T]he unique nature of bankruptcy proceedings, combined with the public policy interest in promoting successful reorganizations, often favors tolerance of greater procedural flexibility in bankruptcy cases. Concepts of finality, for example, are less concrete in the bankruptcy context and, thus, principles disfavoring appeal of orders that do not dispose of an entire case are often less rigorously adhered to in bankruptcy cases.[89]

---

[86] No. 6:06bk-00620-KSJ, 2006 Bankr. LEXIS 1234, at *22 (Bankr. M.D. Fla. May 5, 2006).

[87] *See infra* pp. 122–23 (discussing the procedure for pursuing an interlocutory appeal).

[88] *See In re* Orr, 180 F.3d 656, 659 (5th Cir. 1999) ("There is, therefore, a lower threshold for meeting the 'final judgments, orders, and decrees' appealability standard under 28 U.S.C. § 158(a) than there is for the textually similar 'final decisions' appealability standard under 28 U.S.C. § 1291."); the Fifth Circuit has made clear that a bankruptcy appeal from the district court in which the district court has withdrawn the reference from the bankruptcy court—even though governed by section 1291 as opposed to section 158—is subject to the same finality analysis as any other bankruptcy appeal. *In re* Cajun Elec. Power Coop., Inc., 69 F.3d 746, 747–48 (5th Cir. 1995).

[89] *In re* Transtexas Gas Corp., 303 F.3d 571, 580 (5th Cir. 2002).

In rejecting the usual rule for finality, the Fifth Circuit has made the following observations about the needs of the bankruptcy system and the preservation of the resources of the judicial system and the parties:

> [A] determination that appellate jurisdiction arises only when the bankruptcy judge enters an order which ends the entire bankruptcy case, leaving nothing for the court to do but execute the judgment, would substantially frustrate the bankruptcy system. This is so particularly when, as here, one independent decision materially affects the rest of the bankruptcy proceedings. Separate and discrete orders in many bankruptcy proceedings determine the extent of the bankruptcy estate and influence creditors to expend or not to expend effort to recover monies due them. The reversal of such an order would waste exorbitant amounts of time, money, and labor and would likely require parties to start the entire bankruptcy process anew. This potential waste of judicial and other resources has influenced this Court and other courts of appeals to view finality in bankruptcy proceedings in a more practical and less technical light.[90]

To be final, the order "must constitute either a final determination of the rights of the parties to secure the relief they seek or a final disposition of a discrete dispute within the larger bankruptcy case."[91]

The Fifth Circuit has addressed whether particular orders are final in numerous cases.[92]

The Fifth Circuit has held that other types of orders do not satisfy even the relaxed finality standard.[93]

---

[90] *In re* England, 975 F.2d 1168, 1171 (5th Cir. 1992).

[91] *In re* Bartee, 212 F.3d 277, 282 (5th Cir. 2000) (citations and internal quotations omitted); *see In re* Saco Local Dev. Corp., 711 F.2d 441, 444 (1st Cir. 1983) (containing a comprehensive discussion of finality for purposes of appeal).

[92] *See, e.g., In re* Orso, 283 F.3d 686, 690 (5th Cir. 2002) ("The bankruptcy court's denial of an objection to a debtor's claim of exemption is a final order, subject to immediate appeal."); *In re Bartee*, 212 F.3d at 283 ("Recognition that the denial of a Chapter 13 plan can be a final order is all but compelled by considerations of practicality."); *In re Orr*, 180 F.3d at 659 (order granting summary judgment based on contention that "the tax liens do not attach to . . . post-discharge income distributions from" a trust is final); *In re* Cajun Elec. Power Coop., Inc., 119 F.3d 349, 354 (5th Cir. 1997) (order approving settlement "brings to an end the protracted litigation over the River Bend nuclear project and various other claims among" the parties); *In re* Chunn, 106 F.3d 1239, 1241 (5th Cir. 1997) ("orders granting relief from a § 362 automatic stay are final and appealable"); *In re Cajun Elec. Power Coop., Inc.*, 69 F.3d at 748 (holding than an order appointing a trustee is a Chapter 11 case is final); *In re* Eagle Bus Mfg., Inc., 62 F.3d 730, 734 (5th Cir. 1995) ("[T]he order granting the motions to file untimely proofs of claim is final and appealable because, unlike the cases cited above, the bankruptcy court was left with no dispute or issue to resolve after entering the order."); *In re England*, 975 F.2d at 1172 ("An order which grants or denies an exemption will be deemed a final order for the purposes of 28 U.S.C. § 158(d)."); *In re* Moody, 849 F.2d 902, 904 (5th Cir. 1988) (holding that an order allowing a claim or priority that determines the amount due to a creditor is final); *In re* La. World Exposition Inc., 832 F.2d 1391, 1396 (5th Cir. 1987) (holding that an order finally determining an adversary proceeding is appealable); *In re* Lift & Equip. Serv., Inc., 816 F.2d 1013, 1015–16 (5th Cir. 1987) (explaining that an order recognizing a creditor's security interest is final).

[93] *See*, *e.g.*, *In re* Wood & Locker, Inc., 868 F.2d 139, 144 (5th Cir. 1989) ("We therefore hold that given the clear mandate of Bankruptcy Rule 7054, no appeal may be taken from a bankruptcy court order that adjudicates fewer than all of the claims or the rights and liabilities of fewer than all of the parties in an adversary proceeding absent Rule 54(b) certification—even if the order would be considered final if it arose in another context."); *In re* Tex. Extrusion Corp., 844 F.2d 1142, 1155 (5th Cir. 1988) ("order approving a disclosure statement is not a final order for purposes of appeal but instead is an interlocutory order"); S.C. of Okaloosa, Inc. v. Sunnyside Timber LLC, 81 Fed. Appx. 840, 841 (5th Cir. 2003) ("The order granting the motion to enforce a settlement agreement was interlocutory.").

IV. Procedural Rules

The procedural rules governing an appeal from the bankruptcy court to the district court are contained in rules 8001-8020 in the Federal Rules of Bankruptcy Procedure.[94] Many federal district courts also have local rules applicable to bankruptcy appeals. Of note, the Judicial Conference of the United States' Advisory Committees on Bankruptcy Rules has proposed a substantial package of amendments designed to conform these rules to the Federal Rules of Appellate Procedure.

A. The Notice of Appeal

Bankruptcy appeals move quickly.[95] The expedited nature of these appeals begins with the time to file a notice of appeal—fourteen days.[96] The notice of appeal must (i) comply with the Official Form (Form No. 35), (ii) contain the names of the parties to the judgment and the names, addresses, and telephone numbers of the parties' attorneys, and (iii) be submitted with the required fee.[97] A notice of cross-appeal must be filed within fourteen days of the date on which the first notice of appeal is filed.[98] A premature notice of appeal is treated as if it were filed on the date of the entry of judgment.[99] The notice of appeal should be filed with the bankruptcy court clerk; however, if the notice of appeal is "mistakenly" filed with the district court, the notice of appeal is considered filed in the bankruptcy court on the date it is filed in the district court.[100]

As in an ordinary federal appeal, the time to perfect an appeal may be extended upon the filing of specific post-judgment motions. If a party files a motion to amend or make additional findings under Rule 7052, a motion to alter or amend the judgment or for new trial under Rule 9023, or for relief under Rule 9024, "the time for appeal for all parties runs from the entry of the order disposing of the last such motion outstanding."[101] A prematurely filed notice of appeal is "ineffective" until the bankruptcy court enters an order disposing of the last outstanding post-judgment motion.[102]

The filing of a notice of appeal divests the bankruptcy court of jurisdiction over the matter being appealed.[103] If the appeal, however, involves an interlocutory order, the bankruptcy court is not divested of jurisdiction over the matter on appeal.[104]

---

[94] To expedite an appeal, the district court may suspend any of the rules except Rule 8001, 8002, and 8013. FED. R. BANKR. P. 8019.

[95] *See* FED. R. BANKR. P. 8002 advisory committee's note ("The shortened time is specified to obtain prompt appellate review, often important to the administration of a case under the Code.").

[96] FED. R. BANKR. P. 8002(a).

[97] FED. R. BANKR. P. 8001(a).

[98] FED. R. BANKR. P. 8002(a).

[99] *Id*.

[100] *Id*.

[101] FED. R. BANKR. P. 8002(b).

[102] *Id*.

[103] *In re* Transtexas Gas Corp., 303 F.3d 571, 578–79 (5th Cir. 2002).

[104] *In re* U.S. Abatement Corp., 39 F.3d 563, 567 (5th Cir. 1994).

B. Interlocutory Appeals

To appeal an interlocutory order, a party must file a notice of appeal in compliance with Rule 8001(a) and a motion for leave to appeal.[105] A motion for leave to appeal must contain: (i) a statement of facts; (ii) a statement of the issues to be presented on appeal and the relief sought; (iii) a statement of why leave to appeal should be granted; and (iv) a copy of the order the party seeks to appeal.[106] The appellee has fourteen days to file an opposition to the motion for leave to appeal.[107] The clerk of the bankruptcy court will transmit "the notice of appeal, the motion for leave to appeal, and any answer" to the motion after the time to file an answer has passed.[108] The bankruptcy clerk may not necessarily follow this timing and may transmit the notice of appeal and motion for leave to appeal before the time to answer has passed. In that case, the appellee should file its answer in the district court within the fourteen-day window provided by Rule 8003(a). Neither section 158(a)(3) nor Rule 8003 require the bankruptcy court to certify the case for interlocutory appeal. The decision about whether an interlocutory appeal should go forward rests with the district court.

Rule 8003(c) provides a safety valve if the appellant files a notice of appeal but does not file the required motion for leave to appeal. Under Rule 8003(c), the district court may (i) grant leave to appeal even without a motion for leave to appeal on file, or (ii) order the appellant to file a motion for leave.[109]

Although section 158 does not specify the criteria for determining whether to grant leave to hear an interlocutory appeal in a particular case, many courts have adopted by reference the standard set forth in 28 U.S.C. § 1292(b), which dictates the circumstances under which courts of appeals may accept interlocutory appeals from district courts.[110] Under section 1292(b), an interlocutory appeal may be granted when (1) the order appealed from involves a controlling question of law (2) as to which there is substantial ground for difference of opinion and (3) an immediate appeal from the order would materially advance the ultimate termination of the litigation[111] In contrast to the new direct appeal provision, even if one of the section 1292(b) factors is satisfied, leave to appeal is not appropriate.[112]

District courts are guided by the basic policy that appellate review should be postponed until after the entry of final judgment, and that "exceptional circumstances" must exist that warrant an interlocutory appeal.[113] "Interlocutory appeals are not favored because

---

[105] FED. R. BANKR. P. 8001(b).

[106] FED. R. BANKR. P. 8003(a).

[107] *Id*.

[108] FED. R. BANKR. P. 8003(b).

[109] FED. R. BANKR. P. 8003(c).

[110] *See* Ichinose v. Homer Nat'l Bank, 946 F.2d 1169, 1177 (5th Cir. 1991) (assuming without deciding that the section 1292(b) test applies).

[111] *See* 28 U.S.C. § 1292(b) (2006).

[112] *See* Atl. Textile Grp., Inc. v. Neal, 191 B.R. 652, 653–54 (E.D. Va. 1996) (all three parts of test must be satisfied for leave to be appropriate); *see also In re* IBI Sec. Serv., Inc. v. Nat'l Westminster Bank USA, 174 B.R. 664, 670–71 (E.D.N.Y. 1994) (an issue of first impression in the Second Circuit, which qualified under the second prong, was insufficient to warrant interlocutory review).

[113] Powers v. Montgomery, No. 3:97-CV-1736-P, 1998 U.S. Dist. LEXIS 4784, at *7 (N.D. Tex. Apr. 1, 1998) ("Leave to appeal a bankruptcy court's interlocutory order should be granted only in circumstances which justify overriding the general policy of not allowing such appeals."); *In re* Hunt Int'l Res. Corp., 57 B.R. 371, 372 (N.D. Tex. 1985).

they interfere with the overriding goal of the bankruptcy system, namely, the [expeditious] resolution of pressing economic difficulties."[114]

An order in an adversary proceeding disposing of less than all of the parties or claims is not final.[115] In that circumstance, using the interlocutory appeal procedure would be appropriate. However, a better approach may be the filing of Rule 7054 motion making the interlocutory order final "upon an express determination that there is no just reason for delay and upon an express direction for the entry of judgment."[116]

C. Record and Issue Designations

Within fourteen days of filing the notice of appeal or the district court's granting of a motion for leave to appeal, the appellant must file "a designation of the items to be included in the record on appeal and a statement of the issues to be presented" on appeal.[117] The record and issue designations can be filed as a single document or separately. Within fourteen days of the filing of the appellant's record and issue designations, the appellee may file a designation of additional items to be included in the record on appeal.[118] In a cross-appeal, the appellee as cross-appellant must file issue and record designation within fourteen days of the filing of the appellant's record and issue designations.[119] The cross-appellee then has fourteen days to file a designation of additional items to be included in the record on appeal.[120]

The appellate record consists of the items designated by the parties, the notice of appeal, the judgment, order, or decree on appeal, any opinion, findings of fact or conclusions of law.[121] The record may only consist of items that were before the bankruptcy court.[122] The party designating items for inclusion in the record must provide a copy of those items to the bankruptcy clerk.[123] A party designating a hearing transcript for inclusion in the record must promptly make arrangements with the court reporter for the preparation and filing of the transcript.[124] Both parties are responsible for making sure the appellate record is complete.[125]

---

[114] *Powers*, 1998 U.S. Dist. LEXIS 4784, at *5; *see also* Katchen v. Landy, 382 U.S. 323, 328 (1966); *In re* Durensky, 519 F.2d 1024, 1028 (5th Cir. 1975); *In re* Hayes Bankr., 220 B.R. 57, 59 (N.D. Iowa 1998) ("[D]istrict courts exercise this discretionary power of [interlocutory] review with care, and with an eye toward safeguarding the bankruptcy court's role as the initial and in some respects primary forum for the adjudication of bankruptcy disputes.").

[115] *See In re* Wood & Locker, Inc., 868 F.2d 139, 146 (5th Cir. 1989) (holding that "because the bankruptcy court's grant of summary judgment did not adjudicate all of the claims or the rights and liabilities of all of the parties in the adversary proceeding below, the parties' failure to obtain Rule 54(b) certification left the order interlocutory in nature").

[116] *See* FED. R. BANKR P. 7054; *In re Wood & Locker, Inc.*, 868 F.2d at 143–44 ("[N]o appeal may be taken from a bankruptcy court order that adjudicates fewer than all of the claims or the rights and liabilities of fewer than all of the parties in an adversary proceeding absent Rule 54(b) certification—even if the order would be considered final if it arose in another context."); DeMelo v. Woolsey Marine Indus., Inc., 677 F.2d 1030, 1034 & n.9 (5th Cir. 1982) (characterizing section 1292(b) as more demanding than Rule 54(b)).

[117] FED. R. BANKR. P. 8006.

[118] *Id*.

[119] *Id*.

[120] *Id*.

[121] *Id*.

[122] *See In re* Saco Local Dev. Corp., 13 B.R. 226, 229 (Bankr. D. Me. 1981) (holding that matters not presented to the court prior to issuance of the order being appealed could not be included in the record).

[123] FED. R. BANKR. P. 8006.

[124] *Id*.

If a party fails to take the necessary steps to ensure that the record is complete, it cannot complain about the absence of particular items from the record.[126]

Once the appellate record is complete, the bankruptcy clerk is required to transmit the record to the district court.[127] Upon transmission of the record to the district court, the district clerk will docket the appeal and notify the parties that the appeal has been docketed.[128]

Parties may dispute record designations by filing a motion to strike the opposing party's record designations. It is unclear what authority the bankruptcy court has to rule on such motions. First, under Rule 8006, the bankruptcy court has no discretion in determining the scope of the record.[129] Second, under the divestiture rule, the bankruptcy court lacks jurisdiction over the appeal once the notice of appeal is filed.[130]

Noncompliance with Rule 8006 is not jurisdictional but may lead to dismissal of the appeal.[131] When a party fails to timely designate the issues on appeal but does designate the record and timely file its appellant's brief, the district court abuses its discretion in dismissing the appeal.[132] An issue on appeal is waived if not listed in the designation of issues.[133]

The Fifth Circuit recently addressed the significance of issue designations in the context of a direct appeal in *Smith v. H.D. Smith Wholesale Drug Co. (In re McCombs)*.[134] The Court began its discussion of issue designations reaffirming its prior holding that the failure to designate an issue under Rule 8006—even if that issue was raised in the bankruptcy court and included in appellate briefing at the district court—waives that issue on appeal to the Fifth Circuit.[135] Addressing that rule's application in the direct-appeal context for the first time, the Court held that because the procedural rules governing appeals apply with equal force to direct appeals, the issue-designation requirement likewise applies.[136] An appealing party must either

---

[125] *In re* Ichinose, 946 F.2d 1169, 1173–74 (5th Cir. 1991).

[126] *Id*.

[127] FED. R. BANKR. P. 8007(b).

[128] *Id*.

[129] *See* FED. R. BANKR. P. 8006 ("The record on appeal shall include the items so designated by the parties. . . ."); *In re Ichinose*, 946 F.2d at 1173 ("The record on appeal will include the items designated by both parties.").

[130] *See In re* Transtexas Gas Corp., 303 F.3d 571, 579 (5th Cir. 2002); *but see In re* Carlson, 247 B.R. 754, 756 (Bankr. N.D. Ill. 2000) ("That [bankruptcy] judge does retain, however, some limited authority to act in aid of the appeal process. Questions concerning what items should be included in the designation of record can be resolved in aid of the appeals process."); *In re* Schwinn Bicycle Co., 204 B.R. 13, 16 (Bankr. N.D. Ill. 1997) ("some limited power is retained to determine issues concerning what items should be included in the designation of record"); *In re* Barrick Grp., Inc., 100 B.R. 152, 154 (Bankr. D. Conn. 1989) ("While the filing of a notice of appeal generally divests a bankruptcy court of jurisdiction to proceed with respect to matters raised by the appeal, . . . actions in aid of appeal are not beyond its [bankruptcy court's] authority. . . . Such actions include those intended to ensure that the district court is afforded a complete understanding of the proceedings in the bankruptcy court. I therefore conclude that the bankruptcy court should determine in the first instance whether a disputed item in a designation of record on appeal played any part in its deliberations. . . .").

[131] FED R. BANKR. P. 8001(a).

[132] *See In re* CPDC, Inc., 221 F.3d 693, 700–01 (5th Cir. 2000); *see also* Smoker v. Hill & Assocs., Inc., 204 B.R. 966, 970 (N.D. Ind. 1997) (declining to dismiss appeal in which appellant timely filed its brief but did not file its designation of record or issues).

[133] *See In re* GGM, P.C., 165 F.3d 1026, 1032 (5th Cir. 1999).

[134] 659 F.3d 503 (5th Cir. 2011).

[135] 659 F.3d at 510 (party identified different issues in its appellate briefing than contained in the Rule 8006 designation).

[136] *Id*. at 511.

timely file a Rule 8006 issue designation or file the issue designation required by Rule 6 within fourteen days of the Fifth Circuit's decision to allow the direct appeal to proceed.[137]

D. Briefing the Appeal

Under the Federal Rules of Bankruptcy Procedure, the appellant's brief is due within fourteen days of the docketing of the appeal.[138] The appellee's brief is due within fourteen days of service of the appellant's brief.[139] In a cross-appeal, the appellee's brief should contain the response to the appellant's brief as well as the arguments relevant to the cross-appeal.[140] The appellant's reply brief is due within fourteen days of service of the appellee's brief.[141] In a cross-appeal, the appellee may file a reply brief in support of the cross-appeal within fourteen days of the service of the appellant's reply brief.[142] Supplemental briefs may only be filed with leave of court.[143]

The appellant's brief must contain: (i) a table of contents and authorities; (ii) a statement regarding jurisdiction; (iii) a statement of issues presented and the standard of review; (iv) a statement of the case and statement of facts; (v) summary of argument; and (vi) argument and authorities.[144] The appellee's brief must include the same sections, except that a statement regarding jurisdiction, statement of the case, and a statement of the issues is not required "unless the appellee is dissatisfied with the statement of the appellant."[145] In preparing the appellate briefs, it is important to keep in mind that under Rule 8013, the district court cannot set aside factual findings unless they are clearly erroneous, and the district court must defer to the bankruptcy court with regard to the credibility of the witnesses. The principal briefs are limited to fifty pages, and any reply brief cannot exceed twenty-five pages.[146]

E. Stays Pending Appeal

Rule 8005 allows the bankruptcy court or district court to issue a stay pending appeal, approve a supersedeas bond, or grant "other relief pending appeal."[147] Any such motion must first be presented to the bankruptcy court.[148] In adversary proceedings, Federal Rule of Civil Procedure 62 automatically stays enforcement of the judgment for fourteen days.[149]

A district court's judgment on appeal is automatically stayed for fourteen days.[150] The district court may stay its judgment pending appeal for thirty days and may extend that

---

[137] *Id*.

[138] FED. R. BANKR. P. 8009(a)(1).

[139] FED. R. BANKR. P. 8009(a)(2).

[140] *Id*.

[141] FED. R. BANKR. P. 8009(a)(3).

[142] *Id*.

[143] *Id*.

[144] FED. R. BANKR. P. 8010(a)(1)(A)–(E).

[145] FED. R. BANKR. P. 8010(a)(2).

[146] FED. R. BANKR. P. 8010(c).

[147] FED. R. BANKR. P. 8005.

[148] *Id*.

[149] FED. R. BANKR. P. 7062.

[150] FED. R. BANKR. P. 8017(a).

time period "for cause shown."[151] A stay pending appeal can continue until the case has been resolved by the court of appeals if the appellant notices an appeal to the court of appeals before a previously granted stay expires.[152] The district court has authority to require the posting of security as a condition of granting a stay pending appeal.[153] These rules do not affect the court of appeals' power to issue a stay or preserve the status quo pending appeal.[154]

F. Oral Argument

Rule 8012 states that oral argument will occur "in all cases unless the district judge ... determine[s] that oral argument is not needed."[155] If you think oral argument will be useful, it is advisable to include a statement regarding oral argument in your principal brief.[156] The court will decide the case on the briefs and record if "(1) the appeal is frivolous; (2) the dispositive issue or set of issues has been recently authoritatively decided; or (3) the facts and legal arguments are adequately presented in the briefs and record and the decisional process would not be significantly aided by oral argument."[157] As a practical matter, very few bankruptcy appeals to the district court will be argued orally.

V. Appeals to the Court of Appeals

In an ordinary (*i.e.*, nondirect) appeal to the court of appeals, refer to Federal Rule of Appellate Procedure 6. Rule 6 distinguishes cases in which the district court has exercised its original jurisdiction from those in which it has exercised its appellate jurisdiction under section 158.[158] When the district court has exercised its original jurisdiction, the appeal "is taken as any other civil appeal under these rules."[159] In contrast, when the district court has exercised its appellate jurisdiction, Rule 6 requires additional procedural steps and addresses issues unique to bankruptcy appeals from the district court or bankruptcy appellate panel.[160] You should not assume that the district clerk or the court of appeals' clerk is aware of these distinctions. The notice of appeal in either case is due within thirty days of entry of judgment.[161]

If a party files a timely motion for rehearing under Federal Rule of Bankruptcy Procedure 8015, the time to appeal runs from the entry of any order disposing of the motion for rehearing.[162] A premature notice of appeal is considered timely filed on the date the district court overrules the motion for rehearing.[163] In appeals from a district court judgment issued under the district court's appellate jurisdiction, the appellant must file – within fourteen days

---

[151] FED. R. BANKR. P. 8017(b).

[152] *Id.*

[153] *Id*.

[154] FED. R. BANKR. P. 8017(c).

[155] FED. R. BANKR. P. 8012.

[156] *See id.* ("Any party shall have an opportunity to file a statement setting forth the reason why oral argument should be allowed.").

[157] *Id.*

[158] *See* FED. R. APP. P. 6.

[159] FED. R. APP. P. 6(a).

[160] *See* FED. R. APP. P. 6(b).

[161] FED. R. APP. P. 4(a)(1).

[162] FED. R. APP. P. 6(b)(2)(A)(i).

[163] *Id*.

of filing the notice of appeal – record and issue designations with the circuit clerk.[164] The appellee may file a designation of additional items to be included in the record on appeal within fourteen days of the service of appellant's record and issue designations.[165] The appellate record will contain: (i) the designated items; (ii) the district court proceedings; and (iii) a certified docket sheet from the district court.[166]

The court of appeals' jurisdiction (except in direct appeals and certified interlocutory appeals) is grounded in section 158(d)(1): "The courts of appeals shall have jurisdiction of appeals from all final decisions, judgments, orders, and decrees entered under subsections (a) and (b) of this section."[167] Thus, the court of appeals can only review final judgments from the district court unless (i) a party obtains certification under section 1292(b), or (ii) the court of appeals agrees to hear a direct appeal under section 158(d)(2).

The finality of the district court's judgment is affected by the relief ordered (*e.g.,* rendition versus remand). The flexible standard for finality discussed *supra* at pp. 119-20 likewise applies to appeals under section 158(d).[168] The Fifth Circuit uses a two-step inquiry to decide whether a judgment is final under section 158(d). First, the bankruptcy court's order must be final.[169] If the order is final, the court then turns to whether any remand by the district court requires "extensive further proceedings."[170] "[W]hen a district court sitting as a court of appeals in bankruptcy remands a case to the bankruptcy court for significant further proceedings, the remand order is not 'final' and therefore not appealable under § 158(d)."[171] Whether the district court's judgment is final turns on whether the remand requires ministerial (entry of judgment) or judicial functions (further fact finding).[172] "But an interlocutory appeal may gain finality at the district court level if the district court's order leaves nothing for the bankruptcy court to do but enter the final order."[173]

VI. Conclusion

This article has provided an overview of the unique procedural rules and some of the difficult jurisdictional questions that can arise in a bankruptcy appeal. These rules are generally designed to expedite the briefing and consideration of a wide variety of final and interlocutory bankruptcy court orders. These rules require swift action and careful consideration of requirements such as record and issue designations not required in other federal appeals. Congress has enacted a procedure that allows parties to seek direct appellate review in the courts of appeals when specified criteria are satisfied. This procedure is increasingly being used to resolve unsettled questions and to bring bankruptcy litigation to a more efficient conclusion. It is possible that in the coming years many of the Federal Rules of

---

[164] FED. R. APP. P. 6(b)(2)(B)(i).

[165] FED. R. APP. P. 6(b)(2)(B)(ii).

[166] FED. R. APP. P. 6(b)(2)(B)(iii).

[167] 28 U.S.C. § 158(d)(1) (2006).

[168] *See In re* Orr, 180 F.3d 656 (5th Cir. 1999).

[169] *In re* Greene Cnty. Hosp., 835 F.2d 589, 595 (5th Cir. 1988).

[170] *Id*.

[171] *In re* Nichols, 21 F.3d 690, 692 (5th Cir. 1994).

[172] *In re* Aegis Specialty Mktg., 68 F.3d 919, 921 (5th Cir. 1995).

[173] *In re Greene Cnty. Hosp.*, 835 F.2d at 591 n.9.

Bankruptcy Procedure will be amended to conform these rules to the Federal Rules of Appellate Procedure.

THE INTERSECTION OF THE DODD-FRANK ACT AND THE FOREIGN CORRUPT PRACTICES ACT:

WHAT ALL PRACTITIONERS, WHISTLEBLOWERS, DEFENDANTS, AND CORPORATIONS NEED TO KNOW

Joel Androphy & Ashley Gargour*

TABLE OF CONTENTS

* Joel Androphy is a partner at Berg & Androphy (http://www.bafirm.com) and the author of the six-volume treatise, White Collar Crime, Thompson/West (2010) and Federal False Claims Act and Qui Tam Litigation, Law Journal Press (2011), the research sources for the issues discussed in this article. Androphy, with Sarah Frazier and Ashley Gargour, recently represented John O'Shea, an ABB manager, in his acquittal of FCPA charges.

Ashley Gargour is an associate at Berg & Androphy.

I. Introduction

With the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act),[1] government authorities are no longer the only ones with a monetary interest in ferreting out those who violate federal laws. Specifically, section 922 of the Dodd-Frank Act provides a whistleblower program that rewards individuals who assist the Securities and Exchange Commission (SEC) in uncovering securities violations, including Foreign Corrupt Practices Act (FCPA) violations. Because the Dodd-Frank Act allows individual whistleblowers to reap significant benefits by reporting offenders and because the SEC and Department of Justice (DOJ) have increased FCPA prosecutions in recent years, global companies and their employees, especially those in the pharmaceutical and medical device industry, should understand how the Dodd-Frank Act and the FCPA intersect.

II. The Dodd-Frank Act and the SEC Whistleblower Program

A. Overview of the SEC Whistleblower Program

The SEC's whistleblower program was implemented under section 922 of the Dodd-Frank Act and is primarily intended to reward individuals who provide original information to the SEC that leads to a successful enforcement action. Dodd-Frank also prohibits retaliation by employers against individuals who provide the SEC with information about possible securities violations. The protection from retaliation extends to all whistleblowers, irrespective of whether the whistleblower qualifies for an award.

In passing the Dodd-Frank Act, Congress substantially expanded the agency's authority to compensate individuals who provide the SEC with information about violations of the federal securities laws. Under Dodd-Frank, awards can now be up to thirty (30) percent of the monetary sanctions or recovery obtained by the SEC.

Before turning to the rules regarding the SEC's whistleblower program, it is worth noting what the rules do not require. In adopting the final rules, the SEC rejected a proposal in which employees would have been required to internally report their information to management before being eligible to present information under the SEC's whistleblower program. Instead, the program provides incentives for whistleblowers to report internally when it is appropriate to do so.

B. Requirements of an SEC Whistleblower (17 C.F.R. § 240.21F-3, -4)

To be eligible for an award under the SEC whistleblower program, a whistleblower must: (1) voluntarily provide the SEC, (2) with original information that (3) leads to the successful enforcement by the SEC of a federal court or administrative action, (4) in which the SEC obtains monetary sanctions totaling more than $1 million. Each of these requirements is explained in turn:

1. A whistleblower is deemed to have provided information voluntarily if the whistleblower has provided information before the government, a self-regulatory organization or the Public Company Accounting Oversight Board asks for it directly from the whistleblower or the whistleblower's representative.

---

[1] Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, 1841 (2010).

2. Original information must be based upon the whistleblower's independent knowledge or independent analysis, not already known to the Commission and not derived exclusively from certain public sources.

3. A whistleblower's information can be deemed to have led to a successful enforcement action if: (1) the information is sufficiently specific, credible and timely to cause the SEC to open a new examination or investigation, reopen a closed investigation, or open a new line inquiry in an existing examination or investigation; (2) the conduct was already under investigation when the information was submitted, and the information significantly contributed to the success of the action; or (3) the whistleblower reports original information through his or her employer's internal whistleblower, legal, or compliance procedures before or at the same time it is passed along to the SEC; the employer provides the whistleblower's information (and any subsequently-discovered information) to the SEC; and the employer's report satisfies prongs (1) or (2) above.

4. With regard to the $1 million requirement, the rules permit aggregation of multiple SEC cases that arise out of a common nucleus of operative facts as a single action. These may include proceedings involving the same or similar parties, factual allegations, alleged violations of the federal securities laws, or transactions or occurrences.

C. Excluded as SEC Whistleblowers (17 C.F.R. 240.21F- 4(b)(4))

Under the SEC Whistleblower program, certain people generally will not be considered for whistleblower awards, including:

- People who have a pre-existing legal or contractual duty to report their information to the Commission;

- Attorneys (including in-house counsel) who attempt to use information obtained from client engagements to make whistleblower claims for themselves (unless disclosure of the information is permitted under SEC rules or state bar rules);

- People who obtain the information by means or in a manner that is determined by a U.S. court to violate federal or state criminal law;

- Foreign government officials;

- Officers, directors, trustees or partners of an entity who are informed by another person (such as by an employee) of allegations of misconduct, or who learn the information in connection with the entity's processes for identifying, reporting and addressing possible violations of law (such as through the company hotline).

- Compliance and internal audit personnel; and

- Public accountants working on SEC engagements, if the information relates to violations by the engagement client.

However, under certain circumstances, compliance and internal audit personnel, as well as public accountants, can become whistleblowers when: (1) the whistleblower believes disclosure may prevent substantial injury to the financial interest or property of the entity or investors; (2); the whistleblower believes that the entity is engaging in conduct that will

impede an investigation; or (3) at least 120 days have elapsed since the whistleblower reported the information to his or her supervisor or the entity's audit committee, chief legal officer, chief compliance officer—or at least 120 days have elapsed since the whistleblower received the information, if the whistleblower received it under circumstances indicating that these people are already aware of the information.

Certain other people, such as employees of certain agencies and persons who are criminally convicted in connection with the conduct, are already excluded by Dodd-Frank. In order to prevent wrongdoers from benefitting by, in effect, blowing the whistle on themselves, the rules do not allow the SEC to pay a culpable whistleblower an award that is based on either: (1) the monetary sanctions that such culpable individuals themselves pay in the resulting SEC action or (2) the monetary sanctions paid by entities whose liability is based substantially on conduct that the whistleblower directed, planned or initiated.

D. Enforcement and the Office of the Whistleblower

Although the SEC whistleblower program is still relatively new,[2] the SEC reports an increase in the quality of tips received since Dodd-Frank was passed.[3] Among other activities, the Office of the Whistleblower, established in 2011 by the SEC pursuant to section 924(d) of Dodd-Frank, set up a hotline staffed twenty-four hours a day by attorneys with the Office of the Whistleblower. The hotline received over 900 phone calls between May and November 2011 alone.[4] Whistleblowers from around the country and several foreign countries, including China and the United Kingdom, have submitted tips to the program.[5]

While 170 applicable enforcement judgments were issued from July 21, 2010 through July 31, 2011 that included the imposition of sanctions exceeding the $1 million threshold, no whistleblower awards had been paid as of the end of fiscal year 2011 because the application period for awards had not yet passed.[6] During the fiscal year 2012, 143 enforcement judgments were issued, and the SEC made its first award to a whistleblower under the program.[7]

III. Foreign Corrupt Practices Act

The Dodd-Frank Act's SEC whistleblower program offers substantial rewards to individuals for assisting the SEC in uncovering FCPA violations. Because the number of FCPA investigations has increased, international companies and their employees need to understand the FCPA and how to deter FCPA violations.

---

[2] The final rules became effective August 12, 2011.

[3] Mary L. Shapiro, Chairman, U.S. Sec. & Exch. Comm'n, Opening Statement at SEC Open Meeting: Item 2 – Whistleblower Program (May 25, 2011), *available at* http://www.sec.gov/news/speech/2011/spch052511mls-item2.htm.

[4] U.S. Sec. & Exch. Comm'n, *Annual Report on the Dodd-Frank Whistleblower Program*, (Nov. 2011), *available at* http://www.sec.gov/about/offices/owb/whistleblower-annual-report-2011.pdf.

[5] *Id.*

[6] *Id.*

[7] U.S. Sec. & Exch. Comm'n, *Annual Report on the Dodd-Frank Whistleblower Program*, (Nov. 2012), *available at* http://www.sec.gov/about/offices/owb/annual-report-2012.pdf.

A. Overview of the FCPA

The FCPA subjects U.S. citizens and issuers to criminal liability for payments to foreign officials in order to secure business.[8] Although certain foreign countries have laws similar to the FCPA,[9] the SEC and the DOJ's ability to enforce the FCPA civilly and criminally only extends to American companies and citizens who bribe foreign officials, not the foreign officials who are the bribe recipients—an aspect of the law that causes Americans to be on an uneven playing field in terms of competitive advantages.[10]

1. *Who Is Covered*

The FCPA applies to "issuers," "domestic concerns," or "any persons" other than issuers and domestic concerns in the territory of the United States that take any action to violate the anti-bribery provisions.

An "issuer" is a company whose securities are registered in the United States or who is required to file periodic reports with the SEC.[11] A "domestic concern" includes "a citizen, national, or resident of the United States; and any corporation, partnership, association, joint-stock company, business trust, unincorporated organization, or sole proprietorship that has its primary place of business in the United States or […] is organized under the laws of a State of the United States or" one of its territories, possessions, or commonwealths.[12] Issuers and domestic concerns are liable for acts within the territory of the United States that further a corrupt payment to a foreign official through the use of the U.S. mails or other means of interstate commerce.[13] Issuers and domestic concerns also are liable for acts taken outside of the United States, regardless of whether any means or instrumentalities of interstate commerce were used.

Persons other than nationals of the United States and concerns not organized or resident in the United States also can be liable under the anti-bribery provisions of the FCPA for actions taken within the territory of the United States. There is no requirement that the U.S. mails or other means of interstate commerce be used.

2. *Elements of Bribery*

To prove a violation of the FCPA's anti-bribery provisions, the government must prove the following eight elements:

1. The defendant was a "domestic concern" or an officer, director, employee, or agent of a "domestic concern" or an "issuer" or an officer,

---

[8] *See* 15 U.S.C. § 78dd-2(a) (2006) (domestic concerns); 15 U.S.C. § 78dd-1 (issuers).

[9] *See* S. REP. NO. 95-114, at 4 (1977), *reprinted in* 1977 U.S.C.C.A.N. 4098, 4101 (testimony of Treasury Secretary W. Michael Blumenthal that in many nations, such payments are illegal). For example, in the United Kingdom, the Serious Fraud Office enforces its overseas corruption laws, and in Canada, the Corruption of Public Officials Act is the equivalent of the FCPA in the United States.

[10] *See* United States v. Castle, 925 F.2d 831 (5th Cir. 1991) (per curiam) (holding that foreign officials who take bribes cannot be prosecuted under the FCPA or the general conspiracy statute and discussing the policy decisions behind Congress' decision to exclude foreign officials from prosecution).

[11] *See* 15 U.S.C. § 78dd-1(a).

[12] *See* 15 U.S.C. § 78dd-2(h)(1) (defining "domestic concern").

[13] *See* 15 U.S.C. § 78dd-2(h)(5) (defining "interstate commerce").

director, employee, or agent of such issuer or any stockholder thereof acting on behalf of such issuer;[14]
2. The defendant with respect to the charged conduct specifically intended to make use of the mails or means of interstate commerce;
3. The defendant acted corruptly and willfully;
4. The defendant specifically intended to act in furtherance of a payment—or an offer, promise or authorization for payment—or an offer, gift, promise to give or authorization of the giving of anything of value;
5. The recipients of the payments were "foreign officials;"[15]
6. The defendant knew that all or a portion of the payment was to be offered, given, or promised, directly or indirectly, to a foreign official;
7. The payment was specifically intended to be for one of three purposes: (1) to influence an act or decision of the foreign public official in his or her official capacity; (2) to induce the foreign public official to do or omit to do any act in violation of that official's lawful duty; or (3) to induce that foreign official to use his or her influence with a foreign government or instrumentality thereof to affect or influence any act or decision of such government or instrumentality; and
8. The payment was specifically intended to obtain or retain business for or with, or directing business to, any person.

B. Issues and Ambiguities in FCPA Elements

With the increased number of prosecutions under the FCPA, some of its terms and provisions have received criticism, including the definitions and interpretations of "corruptly and willfully," "knowingly," and "foreign official."

1. *Corruptly and Willfully*

In prosecuting a defendant for an FCPA violation, the government must prove that the defendant acted both corruptly and willfully. A person acts "corruptly" if he acts voluntarily and intentionally, with a bad, wrongful, or improper purpose or evil motive and a specific intent to influence a foreign official to misuse his or her official position to achieve an unlawful result, or a lawful result by some unlawful method or means.[16]

And a person acts "willfully" if he acts deliberately and with the specific intent to do something that the United States laws forbid, that is, with a bad purpose to disobey or disregard the law.[17] In other words, the government must prove that the defendant acted with knowledge that his conduct violated United States laws.[18] The defendant must believe the

[14] *See* 15 U.S.C. § 78dd-1(a).

[15] *See* 15 U.S.C. § 78dd-1(f)(1) (2006) (defining "foreign official" but not defining "instrumentality" of a foreign official); 15 U.S.C. § 78dd-2(h)(2) (same).

[16] *See* United States v. Kozeny, 493 F. Supp. 2d 693, 704 (S.D.N.Y. 2007) (defining "corruptly" as being beyond the element of "general intent" present in most criminal statutes and defining it as "a bad or wrongful purpose and an intent to influence a foreign official to misuse his official position"), *aff'd*, 541 F.3d 166 (2d Cir. 2008); *see also* S. REP. NO. 95-114, at 10 (1977), *reprinted in* 1977 U.S.C.C.A.N. 4098, 4108 (According to the Senate Report for the FCPA, "[t]he word 'corruptly' connotes evil motive or purpose, an intent to wrongfully influence the recipient.").

[17] Bryan v. United States, 524 U.S. 184, 190 (1998).

[18] *See* Jury Instructions in United States v. Bourke, No. S2-05-CR-518 (SAS), 2011 U.S. Dist. LEXIS 146545 (S.D.N.Y. Dec. 15, 2011); *Bryan*, 524 U.S. at 191 (holding that to prove that a defendant acted "willfully," the government must prove that the defendant knew his conduct was unlawful); United States v. Kay, 513 F.3d 432, 448–50 (5th Cir. 2007) (holding that proving a defendant acted "willfully" requires the government to prove that the defendant knew his conduct was unlawful).

transaction was illegal. He cannot be convicted of being negligent or mistaken—more is required than that.[19]

Proving that a defendant acted both corruptly and willfully requires the government to prove that the defendant knew his actions violated the FCPA—a difficult burden if the defendant never received FCPA training.

2. *Foreign Official*

Another issue at the center of FCPA prosecutions is the FCPA's definition of "foreign official." The FCPA defines "foreign official" as "any officer or employee of a foreign government or any department, agency, or instrumentality thereof, or of a public international organization, or any person acting in an official capacity for or on behalf of any such government or department, agency, or instrumentality, or for or on behalf of any such public international organization."[20] But the FCPA does not define "instrumentality."[21]

Without defining who is an instrumentality of a foreign official, the government has expanded the definition to cover employees not intended to be covered either under the text of the FCPA or the underlying purpose of the FCPA. For example, the government has recently taken the position that all employees of a government-owned foreign entity are "foreign officials" within the meaning of the statute because the word "instrumentality" in the definition of foreign official includes state-owned or state-controlled foreign entities. Recent FCPA litigation has focused on whether the definition of "instrumentality" includes foreign state-owned entities and their employees.[22]

3. *Knowingly*

An additional hurdle that the government must overcome in an FCPA prosecution is proving that the defendant *knew* that the intended recipient of a payment was a foreign official.[23] American employees and corporations often conduct business in a foreign country with foreign state-owned and state-controlled companies without knowing that the U.S. government will later contend that the employees of these companies are foreign officials. As noted above, whether a person is a foreign official is ambiguous because the statute itself fails to provide adequate guidance on this term, and therefore, proving that a defendant *knew* that a certain employee was a foreign official is a significant burden for the government.

---

[19] *See* Jury Instructions in United States v. Jefferson, No. 1:07-CR-209 (E.D. Va. 2009) (For the knowledge element of the FCPA, the court instructed the jury "If the evidence shows you that the defendant actually believed the transaction was legal, he cannot be convicted, nor can he be convicted of being stupid or negligent or mistaken. More is required than that.").

[20] 15 U.S.C. § 78dd-2(h)(2)(A) (2006); 15 U.S.C. § 78dd-1(f)(1)(A).

[21] *See* 15 U.S.C. § 78dd-2(h)(2)(A); 15 U.S.C. § 78dd-1(f)(1)(A).

[22] *See* United States v. O'Shea, No. 09-629 (S.D. Tex. 2012); United States v. Aguilar, 783 F. Supp. 2d 1108 (C.D. Cal. 2011); United States v. Esquenazi, No. 09-21010, 2010 U.S. Dist. LEXIS 143572 (S.D. Fla. Nov. 19, 2010); United States v. Carson, No. 09-00077, 2011 U.S. Dist. LEXIS 88853 (C.D. Cal. May 18, 2011).

[23] *See* 15 U.S.C. § 78dd-1(f)(2) (defining knowing as used in the FCPA); 15 U.S.C. § 78dd-2(h)(3)(A) (same); *see also* Stipulation re: Further Briefing Regarding Jury Instructions, *Carson*, No. 09-00077 (C.D. Cal. Sept. 21, 2011) (stipulation between the government and the defense that the answer to the court's question, "Must [the defendant] know that the individual is in fact a government official?" is "yes").

C. Statutory Exception and Defenses

In addition to using the above-mentioned ambiguities and issues to defend against an FCPA prosecution, the FCPA expressly provides a statutory exception and two affirmative defenses.

1. *Exception*

Under the FCPA's exception, payments are not in violation of the FCPA if the payments were facilitating or expediting payments to a foreign official "the purpose of which is to expedite or to secure the performance of a routine governmental action"—a defined term under the FCPA.[24] This exception to the FCPA is commonly referred to as the "grease payment" exception.

2. *Affirmative Defenses*

The FCPA sets forth two affirmative defenses: (1) the payments, while a violation of the FCPA, were legal under the written laws of the foreign country, and therefore, defendant should not be convicted of the charges in the indictment;[25] (2) the payment, gift, offer, or promise of anything of value that was made, while a violation of the FCPA, was a reasonable and bona fide expenditure.[26]

IV. Enforcement Trends in FCPA Healthcare Cases

In recent years, FCPA enforcement activity by the SEC and the DOJ has increased sharply. For example, in 2000, the government did not prosecute a single FCPA case, but in 2010, the DOJ's Criminal Division imposed $1 billion in penalties in FCPA cases—the largest in the history of FCPA enforcement.[27]

In the pharmaceutical and medical device industry, American companies are often at an increased risk of FCPA liability because many companies conduct business in foreign countries that have national healthcare systems. These national healthcare systems have publicly-owned and operated hospitals whose health care providers are government employees providing health care services in their official capacities. According to the U.S. government's interpretation of the FCPA, these employees are foreign officials under the FCPA.

Examples of potential FCPA violations include American pharmaceutical companies and their employees paying doctors and health officials abroad to encourage those individuals to order or prescribe their products or paying foreign doctors to oversee clinical trials of drugs and devices. These payments draw the attention of the U.S. government, and if these payments are made to persons who qualify as "foreign officials" under the FCPA, the pharmaceutical company may face civil or criminal charges in the United States.

---

[24] *See* 15 U.S.C. § 78dd-1(b) (2006) (setting forth the exception); 15 U.S.C. § 78dd-2(b) (same); 15 U.S.C. § 78dd-1(f)(3) (defining "routine governmental action"); 15 U.S.C. § 78dd-2(h)(4) (same).

[25] *See* 15 U.S.C. § 78dd-1(c)(1); 15 U.S.C. § 78dd-2(c)(1).

[26] *See* 15 U.S.C. § 78dd-1(c)(2); 15 U.S.C. § 78dd-2(c)(2).

[27] *See* Press Release, Dept. of Justice, Department of Justice Secures More Than $2 Billion in Judgments and Settlements as a Result of Enforcement Actions Led by the Criminal Division (Jan. 21, 2011), http://www.justice.gov/opa/pr/2011/January/11-crm-085.html.

In a speech on November 17, 2009 at the 22nd National Forum on the Foreign Corrupt Practices Act, Lanny A. Breuer, the Assistant Attorney General for the DOJ's criminal division, commented on how the nature of the pharmaceutical industry itself exposes American companies to FCPA liability:

> In some foreign countries and under certain circumstances, nearly every aspect of the approval, manufacture, import, export, pricing, sale and marketing of a drug product may involve a 'foreign official' within the meaning of the FCPA. The depth of government involvement in foreign health systems, combined with fierce industry competition and the closed nature of many public formularies, creates, in our view, a significant risk that corrupt payments will infect the process.[28]

The potential prosecution of pharmaceutical companies should influence these companies' marketing strategies abroad, and company executives should insist that their foreign subsidiaries not pay bribes to foreign health officials or doctors.

As many international pharmaceutical companies have already discovered, the DOJ and SEC have been increasing the number FCPA investigations by examining the entire pharmaceutical and medical device industry.[29] For example, the SEC and DOJ have reportedly investigated AstraZeneca, Lilly Eli & Co., Johnson & Johnson, Medtronic, Merck & Co., and Zimmer; and other companies, including Novo Nordisk and Syncor, have already paid substantial fines for violations of the FCPA.[30] Given the international nature of the industry, pharmaceutical and medical device companies need to be prepared to face FCPA investigations by the DOJ and SEC.

V. Considerations for all Corporate Defendants, Individual Defendants, Whistleblowers, and their Counsel

A. Corporate Defendant's Perspective

Companies that violate the FCPA pay significant fines and penalties, often willingly as a risk-based decision, with the understanding that these sanctions are part of the cost of doing business in foreign countries. The government's primary resolution vehicles for FCPA enforcement actions are plea agreements, deferred prosecution agreements (DPAs), and non-prosecution agreements (NPAs). Rather than endure a lengthy, expensive trial and potentially suffer harm to their business and goodwill, many companies prefer to enter plea agreements, DPAs, and NPAs.[31] Before signing any agreement with the government, companies should be aware that such agreements often require the company to implement a compliance monitoring program, waive the attorney-client privilege, turnover employees' private documents and data,

---

[28] Lanny A. Breuer, Assistant Attorney General, U.S. Dep't of Justice Criminal Div., Address to the 22nd National Forum on the Foreign Corrupt Practices Act (Nov. 17, 2009), http://www.justice.gov/criminal/pr/speeches-testimony/documents/11-17-09aagbreuer-remarks-fcpa.pdf.

[29] *See* Gardiner Harris, *U.S. Inquiry of Drug Makers Is Widened*, N.Y. TIMES, Aug. 13, 2010, www.nytimes.com/2010/08/14/health/policy/14drug.html?_r=3&ref=todayspaper (discussing the increase in DOJ and SEC investigations of major drug and device makers regarding illegal payments to doctors and health officials in foreign countries).

[30] *See* Appendix A attached hereto for a listing of certain drug and device companies and the FCPA issues each has encountered.

[31] *See* Mike Koehler, *The Foreign Corrupt Practices Act in the Ultimate Year of Its Decade of Resurgence*, 43 IND. L. REV. 389, 406 (2010) (noting that "no business entity has publicly challenged either enforcement agency in an FCPA case in the last twenty years").

cut off support for certain employees' legal defense, and terminate the employment of those who do not cooperate with government investigations.

Another arrow in the government's quiver is debarment from participation in federal and state health care programs. Under 42 U.S.C. § 1320A-7, the government has the authority to debar or exclude entities from participation in Medicare and State Health Care Programs.[32] All the disadvantages of plea agreements, DPAs, and NPAs pale in comparison to debarment from participation in these government programs. But as a practical matter, the government rarely imposes this devastating sanction in part because certain companies that bribe foreign officials also do extensive business with various U.S. agencies under government contracts; thus, debarment for these companies penalizes not only the companies, but also the government agency with which they do business.[33]

Knowing all the consequences that accompany FCPA litigation, many companies choose to be proactive and self-report to the DOJ and SEC to take advantage of any leniency that the government might offer. Because a company is often held to a strict liability standard for the acts of its employees, a company should take steps to lessen the probability that it will violate the FCPA. For example, all companies should consider the following preventative measures:

- Train employees on the FCPA and the consequences for U.S. citizens doing business abroad who violate the FCPA's anti-bribery provisions by bribing foreign officials
- Educate employees on the cultural differences in the countries in which the company conducts business
- Caution employees to be mindful of who might be considered a foreign official in third world countries because the government often has extensive "ownership" and "control" over all economic activities, and in recent FCPA actions, the U.S. government has considered employees of state-owned foreign entities to be foreign officials under the FCPA
- Implement an FCPA compliance program, a code of conduct, and specific policies and procedures regarding conducting business in foreign countries
- Incorporate provisions into contracts with intermediaries setting forth strict guidelines on their interaction with foreign government officials and prohibitions on acts that would violate the FCPA
- Provide resources and procedures for employees to report FCPA violations or meet with general counsel to address questionable foreign business practices that might violate the FCPA
- Request an opinion from the Attorney General under 15 U.S.C. § 78dd-2(f) to determine whether prospective conduct would violate the FCPA
- Consider the advantages of self-reporting through voluntary disclosures to the SEC and DOJ if internal investigations reveal violations of the FCPA

---

[32] *See* 42 U.S.C. § 1320A-7 (2006).

[33] *See generally* Drury D. Stevenson & Nicholas J. Wagoner, *FCPA Sanctions: Too Big to Debar?*, 80 FORDHAM L. REV. 775 (2011).

B. Individual Defendant's Perspective

FCPA prosecutions of individuals are not as prevalent as corporate prosecutions. Individuals charged with FCPA violations more likely than not worked at companies that failed to take precautionary measures, implement FCPA policies and procedures, or provide FCPA training. But unlike the companies for which they worked, individuals do not have deep pockets to pay FCPA sanctions. Consequently, many FCPA defendants plead guilty without a fight to avoid the possibility of being sent to prison.

As long as FCPA defendants—both individuals and corporations—enter into plea agreements, DPAs, and NPAs, the government will continue to build its arsenal of "prosecutorial common law" to support its aggressive and slanted interpretation of the FCPA.[34] Court acceptance of plea agreements does not convert the government's pronunciations on the law into sources of legal authority. Indeed, the government's strategy of creating its own would-be common law threatens to strip the federal courts of their judicial power to interpret the FCPA. The federal courts, and not the Department of Justice nor any other division of the executive branch, are the final arbiters of what the FCPA actually provides.[35]

Obstacles in defending an FCPA action that are common to both individual defendants and corporate defendants include obtaining records from foreign countries, hiring experts on foreign law, and gathering related opinions from foreign courts or government agencies regarding the alleged conduct. Given the adversities associated with defending an FCPA case, for many individuals, the process is cost-prohibitive.

C. Whistleblower's Perspective

Much like the False Claims Act (and to a lesser extent the IRS whistleblower program),[36] the SEC's whistleblower program may foster an environment that will lead to more individuals coming forward as whistleblowers. The SEC whistleblower provisions describe the procedures for submitting information to the SEC and for making a claim for an award after an action is brought. The claim procedures provide opportunities for whistleblowers to present their claim before the SEC makes a final award determination. Under the provisions, the SEC will also pay an award based on amounts collected in related actions brought by certain agencies that are based upon the same original information that led to a successful SEC action.

Regarding the increased anti-retaliation provisions, a whistleblower who provides information to the SEC is protected from employment retaliation if the whistleblower possesses a reasonable belief that the information he or she is providing relates to a possible securities law violation that has occurred, is ongoing, or is about to occur. In addition, the rules make it unlawful for anyone to interfere with a whistleblower's efforts to communicate with the SEC, including threatening to enforce a confidentiality agreement.

---

[34] *See Bingham's Michael Levy on the Rise of Prosecutorial Common Law*, 25 CORPORATE CRIME REPORTER 6, (Feb. 7, 2011), http://www.corporatecrimereporter.com/michaellevy020711.htm (describing "prosecutorial common law").

[35] *See* U.S. CONST. art. III, § 1; Marbury v. Madison, 5 U.S. (1 Cranch) 137, 177 (1803) ("It is emphatically the province and duty of the judicial department to say what the law is."); United States v. Nixon, 418 U.S. 683, 704 (1974) (noting that judicial powers cannot be shared with the Executive Branch).

[36] *See* JOEL ANDROPHY, FEDERAL FALSE CLAIMS ACT AND QUI TAM LITIGATIONS, Law Journal Press (2010).

Although the SEC's whistleblower provisions do not require that employee whistleblowers report violations internally in order to qualify for an award, the rules strengthen incentives that had been proposed and add certain additional incentives intended to encourage employees to use their own company's internal compliance programs when appropriate to do so. For example, the rules make a whistleblower eligible for an award if the whistleblower reports internally and the company informs the SEC about the violations. In addition, an employee is considered a whistleblower under the SEC program as of the date that the employee reports the information internally—as long as the employee provides the same information to the SEC within 120 days.

Through this provision, employees are able to report their information internally first while preserving their "place in line" for a possible award from the SEC. More importantly, the rules provide that a whistleblower's voluntary participation in a company's internal compliance program is a factor that can increase the amount of an award, and that a whistleblower's interference with internal compliance and reporting is a factor that can decrease the amount of an award.

VI. Conclusion

Whether the new whistleblower provisions will have a significant or a negligible impact on FCPA enforcement remains to be seen. In any event, corporations, individuals, and their counsel should be aware of the potential consequences associated with FCPA violations and the provisions of the Dodd-Frank Act's SEC whistleblower program.

APPENDIX A - Pharmaceutical and Medical Device Companies and the FCPA

Company	Description of FCPA Issue
AstraZeneca PLC	On April 28, 2011, AstraZeneca disclosed that it received inquiries from the DOJ and SEC in connection with an investigation into FCPA issues in the pharmaceutical industry across several countries. "AstraZeneca is cooperating with these inquiries and is investigating, among other things, sales practices, internal controls, certain distributors, and interactions with healthcare providers, institutions, and other government officials. AstraZeneca is investigating inappropriate conduct in certain countries, including China."[37]
Lilly Eli & Co.	"In August 2003, we received notice that the staff of the SEC is conducting an investigation into the compliance by Polish subsidiaries of certain pharmaceutical companies, including Lilly, with the U.S. Foreign Corrupt Practices Act of 1977."[38]
Johnson & Johnson	In February 2007, J&J voluntarily disclosed to the DOJ and the SEC that non-U.S. subsidiaries may have violated the FCPA through improper payments in connection with the sale of medical devices in two small-market countries.[39] In April 2011, J&J paid $70 million ($21.4 million criminal fine via a DOJ DPA; $48.6 million in disgorgement and prejudgment interest via a SEC settlement) to resolve FCPA enforcement actions for conduct in Greece, Poland, Romania, and an investigation of J&J subsidiary companies in the United Nations Oil-for-Food Program in Iraq.[40] J&J also paid approximately $7.9 million in a related U.K. Serious Fraud Office civil recovery action against its company DePuy International Limited, a subsidiary of DePuy Incorporated.[41]
Medtronic, Inc.	On September 25, 2007, the SEC sent Medtronic a letter requesting information relating to potential FCPA violations, such as payments to government-employed doctors, in connection with the sale of medical devices in foreign countries, including Greece, Poland, Germany, Turkey, Italy, and Malaysia.[42]

[37] AstraZeneca PLC, Annual Report (Form 20-F) 13 (Apr. 28, 2011).

[38] Lilly Eli & Co., Quarterly Report (Form 10-Q) 28 (Apr. 29, 2011).

[39] Johnson & Johnson, Quarterly Report (Form 10-Q) 32 (Aug. 11, 2010).

[40] *See* Press Release, U.S. Dept. of Justice, Johnson & Johnson Agrees to Pay $21.4 Million Criminal Penalty to Resolve Foreign Corrupt Practices Act and Oil for Food Investigations (Apr. 8, 2011), http://www.justice.gov/opa/pr/2011/April/11-crm-446.html.

[41] *See* Press Release, U.K. Serious Fraud Office, DePuy International Limited ordered to pay 4.829 million pounds in Civil Recovery Order (Apr. 8, 2011), http://www.sfo.gov.uk/press-room/press-release-archive/press-releases-2011/depuy-international-limited-ordered-to-pay-4829-million-in-civil-recovery-order.aspx.

[42] Medtronic, Inc., Annual Report (Form 10-K) 36 (June 23, 2009).

Company	Description of FCPA Issue
Merck & Co., Inc.	"The Company has received letters from the DOJ and the SEC that seek information about activities in a number of countries and reference the Foreign Corrupt Practices Act. The Company is cooperating with the agencies in their requests and believes that this inquiry is part of a broader review of pharmaceutical industry practices in foreign countries."[43]
Novo Nordisk A/S	In May 2009, Novo Nordisk pled guilty and paid a $9 million fine for paying $1.4 million to former Iraqi government officials in the UN Oil-for-Food Program for government contracts to provide insulin and other drugs, and Novo also paid $3,025,066 in civil penalties and $6,005,079 in disgorgement of profits.[44]
Syncor Taiwan, Inc.	In December 2002, Syncor pled guilty and paid $2 million in criminal fines and $500,000 in civil penalties.[45]
Zimmer Holdings, Inc.	In September 2007, the SEC informed Zimmer that it was investigating potential FCPA violations in medical device sales in foreign countries by companies, and that in November 2007, the DOJ requested any information provided to the SEC also be provided to the DOJ on a voluntary basis.[46]

[43] Merck & Co., Inc., Quarterly Report (Form 10-Q) 26 (Aug. 6, 2010).

[44] *See* Press Release, U.S. Dept. of Justice, Novo Nordisk Agrees to Pay $9 Million Fine in Connection with Payment of $1.4 Million in Kickbacks Through the United Nations Oil-for-food Program (May 11, 2009), http://www.justice.gov/opa/pr/2009/May/09-crm-461.html.

[45] *See* Press Release, U.S. Dept. of Justice, Syncor Taiwan, Inc. Pleads Guilty to Violating the Foreign Corrupt Practices Act (Dec. 10, 2002), http://www.justice.gov/opa/pr/2002/December/02_crm_707.htm.

[46] Zimmer Holdings, Inc., Annual Report (Form 10-K) 63 (Feb. 25, 2010).

TRANSCENDING DISCIPLINES: WHAT EVERY TRANSACTIONAL LAWYER SHOULD KNOW ABOUT LITIGATION

Brent Benoit*

TABLE OF CONTENTS

---

* Brent Benoit focuses his practice on securities litigation, complex commercial litigation, and internal and governmental investigations. He has represented clients in a wide range of important cases involving issues such as allegations of securities fraud, disputes over merger and acquisition transactions, alleged anti-trust violations, broker/dealer litigation, and energy law issues. He also represents government entities, officers and employees and is well-versed in all aspects of internal and governmental investigations. He has overseen and conducted major internal investigations and represents clients before various governmental organizations including the Department of Justice, Securities and Exchange Commission, and the Office of Foreign Assets Control. His internal investigation and regulatory practice includes a wide range of issues including alleged violations of the Foreign Corrupt Practices Act, regulations of the Office of Foreign Assets Control, Securities and Exchange Commission regulations, executive compensation, anti-trust, and accounting issues. Additionally, Mr. Benoit is President of the Houston Bar Association.

I. Introduction

In many large law firms, transactional lawyers and litigators are divided, herded into separate groups on separate floors in separate offices. But they are often divided by more than just office location. Litigators and transactional attorneys have significantly different practices. Thus, transactional lawyers often do not have an opportunity to learn about some aspects of litigation that could prove helpful in their practices.

Yet it is often the transactional attorney that has the first, and perhaps best, opportunity to take steps that protect the client's litigation position. Accordingly, it is important that transactional attorneys familiarize themselves with certain basic litigation concepts so that they will be equipped to take advantage of these opportunities.

A full discussion of every litigation concept that might prove useful to transactional attorneys is not possible. This paper, however, addresses certain key concepts that should prove useful to a broad range of transactional attorneys. These topics include: litigation holds, "No Oral Modification" clauses, reliance disclaimers, and arbitration clauses.

II. The Litigation Hold – Making Sure You Are Not Behind Before Litigation Starts

In the last two decades, the dominant form of electronic communication has evolved from paper to fax transmissions to e-mail. More and more companies are foregoing the expense and burden of maintaining paper files and opting for the cost-effectiveness that electronic document storage provides.

Unfortunately, technology has substantially complicated discovery in litigation and made it substantially more expensive. Parties must now comb through an enormous amount of electronic data to respond to discovery requests in litigation. The costs to collect, search, and produce this information can be enormous.

Cost is not the only concern electronic data presents. The failure to properly preserve, collect, and produce electronic data can also lead to discovery sanctions. Discovery sanctions can have a host of effects including, but not limited to, the amplification of costs and the infliction of material damage to a party's litigation position. Because transactional attorneys can play a key role in avoiding such outcomes, it is important that they have an understanding of this area.

A party's duty to preserve electronic data often arises well before a lawsuit is filed. Accordingly, a transactional attorney may be the first attorney to interact with the client once this duty arises. Because time is often of the essence, it is important that the client be properly advised regarding electronic discovery obligations so that appropriate steps can be promptly taken. Otherwise, the client may have already violated its obligations by the time a litigation attorney is consulted.

A. The Importance of Proper Data Preservation and Collection

One of the first steps in any litigation is to preserve and collect the relevant data. The preservation of information, particularly electronic data, has received much attention recently. Recent cases have made it clear that the consequences of failing to properly preserve data can be severe.

When parties to a lawsuit are confronted with ostensibly incomplete document production, they can reach the conclusion, whether justified or not, that the opposing party is not sufficiently cooperating, or worse, intentionally concealing some negative information. In cases such as this, parties risk intervention by the courts. If documents have not been properly produced, the client faces a loss of credibility.

The danger, however, is more than a loss of credibility. The failure to preserve and collect the relevant data can have other serious consequences in civil litigation. In a mild case, the results can be additional discovery and document collection costs. In a severe case, the failure to properly preserve and collect data can lead to severe sanctions, including monetary fines, jury instructions on adverse inferences, and other consequences. For some time, a series of opinions known as the *Zubulake* opinions authored by Judge Sheindlin in the Southern District of New York served as the leading opinions in this area of the law.[1]

B. Recent Case Law: Montreal Pension Plan and Rimkus Consulting Group

Recently, Judge Sheindlin revisited the matter in *Pension Committee of University of Montreal Pension Plan v. Banc of America Securities, LLC*.[2] In *Montreal Pension Plan*, the court stated: "By now, it should be abundantly clear that the duty to preserve means what it says and that a failure to preserve records—paper or electronic—and to search in the right places for those records, ***will inevitably result in spoliation***."[3] This sweeping presumption demonstrates the civil litigation importance of preserving records properly at the initiation of a dispute.

In *Montreal Pension Plan*, the court did not confront the destruction of documents. Instead, the conduct at issue was the allegation that the "plaintiffs failed to timely institute written litigation holds and engaged in careless and indifferent collection efforts after the duty to preserve arose."[4] These failures, however, in the eyes of the court left "little doubt that some documents were lost or destroyed."[5]

The court went on to consider what sanctions the plaintiffs should face given their failure to issue written litigation holds and carefully collect documents. The first step of the court's analysis focused on whether the conduct at issue was "negligent," "grossly negligent," or "willful." After defining these various terms, the court went on to analyze the conduct to determine where each party's conduct fit on this continuum. The court concluded that in light of its prior *Zubulake* opinions, it was now the case that "the failure to issue a *written* litigation hold constitutes gross negligence because that failure is likely to result in the destruction of relevant information."[6] The court applied a more nuanced approach to the issue of collection. The court noted that depending on the importance of the document custodians at issue, the failure to collect documents could be anywhere from negligent to willful.[7]

To determine what sanction to impose, the court set forth a sliding scale of the proof required:

---

[1] *See, e.g.,* Zubulake v. UBS Warburg LLC, 220 F.R.D. 212 (S.D.N.Y. 2003); Zubulake v. UBS Warburg LLC, 229 F.R.D. 422 (S.D.N.Y. 2004).

[2] 685 F. Supp. 2d 456 (S.D.N.Y. 2010).

[3] *Id*. at 462 (emphasis added).

[4] *Id*. at 463.

[5] *Id*.

[6] *Id*. at 464–65 (emphasis in original).

[7] *Id*. at 465.

> The burden of proof question differs depending on the severity of the sanction. For less severe sanctions—such as fines and cost-shifting—the inquiry focuses more on the conduct of the spoliating party than on whether the documents were lost, and, if so, whether those documents were relevant and resulted in prejudice to the innocent party. As explained more thoroughly below, for more severe sanctions—such as dismissal, preclusion, or the imposition of an adverse inference—the court must consider, in addition to the conduct of the spoliating party, whether any missing evidence was relevant and whether the innocent party has suffered prejudice as a result of the loss of evidence.[8]

The challenge for parties is that the foregoing structure means that a party who is negligent in preserving or collecting documents could face sanctions ***even if no relevant documents are missing and the opposing party has suffered no prejudice***.

In addition, according to *Montreal Pension Plan*, a party seeking harsh sanctions will not always need to establish relevance and prejudice. The court held that "[r]elevance and prejudice may be ***presumed*** when the spoliating party acted in bad faith or in a grossly negligent manner."[9] This presumption is described as permissive and not one that is required to be made by the reviewing court.[10] If a party's discovery conduct was simply negligent, then the court held that both relevance and prejudice must be established by the complaining party (or presumed as noted above) before harsh sanctions can be imposed.[11] Even in that circumstance, the court held that courts should not apply "too strict a standard of proof" to ensure that offending parties are not allowed to profit from their destruction of evidence.[12]

The court noted that the presumption of relevance and prejudice is always rebuttable. In an effort to balance the playing field, the court adopted a burden shifting test:

> When the spoliating party's conduct is sufficiently egregious to justify a court's *imposition* of a presumption of relevance and prejudice, or when the spoliating party's conduct warrants *permitting* the jury to make such a presumption, the burden then shifts to the spoliating party to rebut that presumption. The spoliating party can do so, for example, by demonstrating that the innocent party had access to the evidence alleged to have been destroyed or that the evidence would not support the innocent party's claims or defenses. If the spoliating party demonstrates to a court's satisfaction that there could not have been any prejudice to the innocent party, then no jury instruction will be warranted although a lesser sanction might still be required.[13]

Of course, it is easy to imagine the difficulty that a party would have in "proving the negative" as to whether any potentially lost evidence would have been relevant or prejudicial. Accordingly, a party who acts in bad faith or in a grossly negligent manner might be subject to severe sanctions even though in reality no relevant information was lost.

---

[8] *Id*. at 467.

[9] *Id*. (emphasis added).

[10] *Id*.

[11] *Id*. at 467–68.

[12] *Id*. at 468.

[13] *Id*. at 468–69 (emphasis in original).

The plaintiffs in *Montreal Pension Plan* were ultimately sanctioned for their conduct. These sanctions were based on various discovery facts. These facts included, but were not limited to, inadequate document holds, entrusting the document collection activity to clients, the admitted destruction of certain evidence such as backup tapes, and incomplete or inaccurate affidavits submitted in response to the discovery sanction motions.

With respect to the issue of document holds, plaintiffs' counsel promptly contacted the plaintiffs and instructed them both orally and in writing to begin collecting and preserving evidence.[14] These efforts, however, were found lacking because the instruction did not require ***all*** relevant records to be preserved and the plaintiffs' counsel relied on the plaintiffs to collect the documents.[15] Therefore, a party can be found to have engaged in discovery conduct even when a litigation hold is in place if the court determines that the litigation hold was defective.

The end result was a finding that several of the plaintiffs acted in a grossly negligent manner.[16] For these plaintiffs, the court ruled that a jury charge would be given that instructed the jury that the parties had preserved evidence in a grossly negligent manner and that the jury was permitted to presume that the lost evidence was relevant and prejudicial, and that the plaintiffs are permitted to attempt to rebut the presumption.[17] In addition, all of the plaintiffs were ordered to pay the defendants' reasonable costs and attorneys' fees associated with sanctions motion, including the discovery conducted related to the sanction motion.[18] Certain plaintiffs were also ordered to search certain backup tapes.[19]

The court summed up the duties of parties in preserving and collecting evidence by articulating what it saw as the "contemporary standards" for the preservation and collection of evidence that must be adhered to in order to avoid a finding of gross negligence:

> After a discovery duty is well established, the failure to adhere to contemporary standards can be considered gross negligence. Thus, after the final relevant *Zubulake* opinion in July, 2004, the following failures support a finding of gross negligence, when the duty to preserve has attached: to issue a written litigation hold; to identify all of the key players and to ensure that their electronic and paper records are preserved; to cease the deletion of email or to preserve the records of former employees that are in a party's possession, custody, or control; and to preserve backup tapes when they are the sole source of relevant information or when they relate to key players, if the relevant information maintained by those players is not obtainable from readily accessible sources.[20]

These are just some of what might be perceived as "minimum standards" for companies in anticipation of litigation.

Shortly after the decision in *Montreal Pension Plan*, Judge Rosenthal in the Southern District of Texas confronted the issue of discovery sanctions in *Rimkus Consulting Group, Inc. v. Cammarata*, but in the context of allegations of intentional document destruction.[21] Rather

---

[14] *Id*. at 473.
[15] *Id*.
[16] *Id*. at 479–88.
[17] *Id*. at 496–97.
[18] *Id*. at 497.
[19] *Id*.
[20] *Id*. at 471.
[21] 688 F. Supp. 2d 598 (S.D. Tex. 2010).

than apply sweeping presumptions, the opinion in *Rimkus Consulting Group* instead adopted a case-specific approach to the issue of spoliation:

> Whether preservation or discovery conduct is acceptable in a case depends on what is *reasonable*, and that in turn depends on whether what was done—or not done—was *proportional* to that case and consistent with clearly established applicable standards.[22]

While the court described this approach as consistent with *Montreal Pension Plan*,[23] it did expressly depart from a few of the holdings in *Montreal Pension Plan*.

First, the court ruled that in the Fifth Circuit serious sanctions (such as default judgments or adverse inference instructions) required a finding of bad faith and could not be supported by a finding of negligence or gross negligence.[24] Second, the court called into question *Montreal Pension Plan*'s holding that relevance, in certain circumstances, can be presumed, noting that case law in the Fifth Circuit stands for the proposition that "an adverse inference instruction is not proper unless there is a showing that the spoliated evidence would have been relevant."[25]

Ultimately, the court in *Rimkus Consulting Group* concluded that sanctions were warranted.[26] The court found that the defendants had intentionally deleted emails after the duty to preserve the emails had arisen.[27] The court also found that the deleted emails would have been helpful to the opposing party.[28] This was determined because several such emails were obtained from alternate sources, a fact that the court found mitigated the need for a severe sanction.[29] As a result, the court provided for a monetary sanction to reimburse the opposing party for various costs and attorneys' fees associated with the discovery issues. The court also ruled that the jury would be instructed that if it decides that the defendants intentionally deleted emails to hide them from discovery, then the jury may, if it chooses, infer that the deleted emails that cannot be produced from alternate sources were adverse to the defendants.[30]

C. Lessons For Your Clients

So what do *Montreal Pension Plan*, *Rimkus Consulting Group*, and similar decisions mean? They mean that courts are looking with an increasingly critical eye at document preservation efforts for civil litigation. Most importantly, courts impose this duty as soon as a

---

[22] *Id*. at 613.

[23] *Id*.

[24] *Id*. at 615 ("In the Fifth Circuit and others, negligent as opposed to intentional, 'bad faith' destruction of evidence is not sufficient to give an adverse inference instruction and may not relieve the party seeking discovery of the need to show that missing documents are relevant and their loss prejudicial."); *See also* Ashton v. Knight Transp., Inc., 772 F. Supp. 2d 772 (N.D. Tex. 2011) (court approved sanctions including striking the pleadings and defenses to liability of a truck company and driver who destroyed electronic communications and other evidence, where company had a duty to preserve the evidence, they purposefully engaged in a concerted effort to hide and destroy it, and the spoliation materially compromised the ability of the victim's widow to present her case).

[25] *Id*. at 617.

[26] *Id*. at 653.

[27] *Id*.

[28] *Id*.

[29] *Id*. at 644–47.

[30] *Id*. at 653. For a helpful canvass of the law in the federal circuit regarding scope of the duty to preserve, as well as the effect of culpability and prejudice on sanctions, *see* Victor Stanley, Inc. v. Creative Pipe, Inc., 269 F.R.D. 497, 541 (D. Md. 2010); *also see* CAROLE BASRI & MARY MACK, EDISCOVERY FOR CORPORATE COUNSEL § 10:2 (2012).

company anticipates litigation. This means if a company awaits the filing of a lawsuit, it may already be too late to engage in what courts see as the appropriate document preservation and collection efforts. This is a failure, at least as far as the *Montreal Pension Plan* decision is concerned, that may be difficult or impossible for a company to recover from given the harsh presumptions that are afforded the requesting party if the expected document preservation and collection steps have not taken place. While *Rimkus Consulting Group* softens this approach somewhat, it still imposed sanctions for the loss of data after a duty to preserve arose. The end result can be serious sanctions that at a minimum will include some monetary award, and at worst, will result in substantive presumptions that materially alter the civil litigation playing field.

As noted above, the need for a proper document retention instruction or proper collection of evidence may exist well before any lawsuit is filed.[31] In *Wal-Mart Stores, Inc. v. Johnson*, the Texas Supreme Court held that the duty to preserve evidence arises "when a party knows or reasonably should know that there is a substantial chance that a claim will be filed and that the evidence in its possession or control will be material and relevant to that claim."[32] Accordingly, a transactional attorney representing a company at the moment a dispute arises or is expected should promptly begin taking steps to protect the client's litigation position by properly preserving relevant information.

Montreal Pension Plan makes it clear that a crucial first step in proper document preservation efforts is for the company to circulate a proper document retention memorandum or litigation hold. The document retention memorandum should be sufficiently broad to cover all relevant information and should provide clear unambiguous instructions to the recipients. Equally important, the memorandum should be distributed to a sufficiently broad number of individuals to ensure that the relevant information is preserved and/or collected. It is also important that counsel follow up with the recipients to ensure that they received it, understood it, and are complying with it.

But, document preservation must extend beyond circulation of a hold memorandum. *Rimkus Consulting Group* holds that what exactly needs to be done will depend on what is reasonable under the specific facts at hand. Of course, the court in *Montreal Pension Plan* was more willing to indulge in inferences based on its notion that certain preservation failures are always at least negligent. However, as this debate resolves itself, it is clear that more needs to be done than the mere circulation of a hold memorandum.

It is crucial that transactional attorneys also be aware of these additional document preservation issues. For example, large companies usually have multiple servers that are each backed up in some fashion, often through the use of backup tapes. These backup tapes are usually circulated according to a rotation schedule. Which of these backup tapes, if any, should be preserved will depend on the particular facts of the dispute or potential dispute. However, prompt action is essential because time is of the essence once litigation is anticipated.

It is for this reason that the most conservative strategy is to immediately suspend the company's rotation process until an informed preservation decision can be made. But, this

---

[31] Pension Comm. of the Univ. of Montreal Pension Plan v. Banc of Am. Sec., LLC, 685 F. Supp. 2d, 456, 466 (S.D.N.Y. 2010) ("A plaintiff's duty is more often triggered before litigation commences, in large part because plaintiffs control the timing of the litigation."). The *Rimkus Consulting Group* opinion concluded that the duty to preserve arises when the party has notice or should have known that the evidence was relevant to "future litigation." Rimkus Consulting Grp., Inc. v. Cammarata, 688 F. Supp. 2d 598, 612 (S.D. Tex. 2010).

[32] 106 S.W.3d 718, 722 (Tex. 2003). *See also Montreal Pension Plan*, 685 F. Supp. 2d at 466 ("It is well established that the duty to preserve evidence arises when a party reasonably anticipates litigation.").

strategy may not always be workable for a number of reasons. For example, the cost may be unreasonably prohibitive. As a further example, the relevant servers may be dispersed around the world and an immediate uniform suspension may not be logistically possible. In such a circumstance, the client should make all reasonable steps to preserve as much relevant information as possible.

Whatever the facts, the underlying point remains the same: time is of the essence in making proper document preservation decisions. Failure to promptly act can have repercussions in civil litigation.[33] For example, in *Montreal Pension Plan*, the court based its decision to award sanctions in part on the failure by certain plaintiffs to preserve backup tapes.[34]

Transactional attorneys are sometimes called upon to gather and produce documents in response to governmental inquiries or subpoenas. Government authorities have become more sophisticated regarding electronic discovery and will normally expect a response to include a search for electronic data. In such situations, the need for prompt and proper steps to preserve and collect documents is clear. However, because the transactional attorney will also be involved in collecting, reviewing and producing documents, it is also important to consider those areas as well. The process of producing electronic data usually involves certain basic steps: collection, processing, searching, and review. Each of the steps should be evaluated not only in the context of the government inquiry, but also in light of any pending or potential civil litigation that may arise.

Governmental inquiries are often predecessors to civil litigation. If civil litigation is anticipated, it is important that the collection of electronic data be defensible in court. There is no per se prohibition on the company collecting the electronic data (as opposed to some third party e-discovery firm) and often this is the most economical way of collecting the data. Nonetheless, such a collection will be viewed with skepticism by governmental authorities and can be questioned by civil plaintiffs in a discovery dispute. Counsel should consider whether the client should be placed in the position of defending the collection efforts. An alternative is to retain a firm with expertise in data collection to collect the data. Reputable firms will collect the data with an established methodology and typically with certified personnel. Often these firms can supply individuals to manage the collection who also have experience testifying regarding their collection techniques.

Once collected, the data must be processed. This typically involves removing certain files that are unlikely to contain relevant data (*e.g.,* program files) and de-duplicating the data. De-duplication involves removing duplicate files and e-mails to speed the review process. The de-duplication effort can be conducted in a number of different ways. Depending on the issues involved, time constraints, and other factors, counsel may believe that the most efficient method is to de-duplicate across the entire document population. This speeds the review because a document is only reviewed once, rather than multiple times. Counsel should consider whether this methodology makes sense if litigation is imminent. Plaintiffs typically will insist that every iteration of a document be produced. For example, a civil litigation plaintiff may want to ask a jury to draw an inference based on who in the company did or did not have a copy of a particular document. Counsel may also want to review similar

---

[33] *See, e.g.,* Super Future Equities, Inc. v. Wells Fargo Bank Minn., N.A., No. 3:06-CV-0271-B, 2008 WL 3261095, at *13–14 (N.D. Tex. Aug. 8, 2008) (awarding sanctions for failure to preserve electronic data); Treppel v. Biovail Corp., 249 F.R.D. 111, 120–21 (S.D.N.Y. 2008) (finding that the failure to preserve backup tapes required the issuance of sanctions).

[34] *See, e.g., Montreal Pension Plan*, 685 F. Supp. 2d at 487 ("That the vendor hired in 2007 was not able to retrieve e-mails from some backup tapes is not surprising given that the recycling of backup tapes was never suspended.").

information. Accordingly, an alternative such as de-duplicating only within a particular custodian's set of documents may be more sensible.

The searching of data is typically performed with search terms. Experienced counsel will carefully craft search terms based on an agreed scope of the relevant inquiry and negotiate with the opposing party to reach agreed search terms. In crafting the search terms for a government inquiry before any litigation is filed, counsel may want to consider crafting search terms that are broad enough to cover matters that are likely to arise in subsequent civil litigation. The benefit of doing so is primarily cost savings. Depending on the vendor, new search terms can be expensive to run. However, typically that is a cost best accepted. Counsel responding to a government inquiry will usually want to avoid collecting documents not needed for the scope of the litigation because over collection can slow the process.

Finally, the actual review of documents should also factor in the potential for litigation. In the course of the review, attorneys conducting document review should be cognizant of any potential litigation claims. This allows the reviewer to note documents that may be particularly relevant to these potential claims, providing the client with the opportunity to jump out to an early start on gathering evidence and organizing its potential defense.

In closing, in the course of a corporate lawyer's work, potentially litigious situations are often encountered. In these circumstances, a duty to promptly preserve evidence may arise. Because of the severe consequences that can occur when document preservation or production is mishandled, it is important for transactional lawyers to inform and advise clients regarding these issues.

III. Problems Enforcing "No Oral Modifications" Clauses

As transactional attorneys know, agreements are often reduced to writing to capture the myriad of terms and conditions inherent in complex commercial deals. In an effort to prevent litigation, confusion, and misunderstanding, many agreements contain "No Oral Modification" clauses that ostensibly require modifications to an agreement to also be in writing. But do they work?

The answer, in short, is typically no. In fact, including these clauses in your clients' contracts could give your clients a false sense of security. Unless the statute of frauds applies, contracts that include "No Oral Modification" clauses can still be modified orally. In fact, such contracts can usually be modified orally as easily as contracts that do not include "No Oral Modification" clauses.[35]

A. Origin of the Rule

That "No Oral Modification" clauses do not prevent subsequent oral modification is a principle firmly rooted in Texas law. In fact, Texas courts have recognized the ineffectiveness of "No Oral Modification" clauses since 1887, when the Supreme Court of Texas decided *Morrison* v. *Insurance Co. of North America*.[36]

---

[35] It is important to note that the following discussion assumes that the Statute of Frauds does not apply. In the event the Statute of Frauds applies, the agreement itself, as well as any subsequent modifications, must be in writing, regardless of whether a "No Oral Modification" clause is present. *See* Dimon v. Trendmaker, Inc., No. 14-96-01081-CV, 1998 WL 19861, at *5–6 (Tex. App.—Houston [14th Dist.] Jan. 22, 1998, no writ).

[36] 6 S.W. 605, 609 (Tex. 1887).

In *Morrison*, the court first articulated the reasoning for the rule as it stands today.[37] *Morrison* involved an insurance agent who gave unwritten consent to "subsequent insurance."[38] In that case, the insurance policy had a clause that the agent "shall not have the power to evidence his consent to subsequent insurance except by a writing . . . ."[39]

In evaluating the effectiveness of the "No Oral Modification" clause in *Morrison*, the court adopted the reasoning of the Michigan Supreme Court and ruled that "a written bargain is of no higher legal degree than a parol one" and, therefore, "[e]ither may vary or discharge the other."[40] For over 120 years, the reasoning in *Morrison* has controlled this aspect of contract law. The law is clear that "any written contract not within the statute of frauds" may be subsequently orally modified.[41]

B. Reasoning for the Rule

Logic suggests that parties should be able to agree that their contract can only be modified by a writing. However, the law sees things differently. As noted above**,** "No Oral Modification" clauses generally have no effect on whether or not an agreement can be subsequently orally modified.[42]

The reason for this rule is that subsequent oral modifications have the same contractual force and effect of law as the written agreement.[43] In other words, "the written agreement is of no higher legal degree than an oral one, and either may vary or discharge the other" even if the original written agreement forbids it.[44] Thus, just as any term in a contract can be modified, the term requiring subsequent modifications to be in writing can be modified by implication by modifying the contract orally subsequently.[45]

For example, in *Mar-Lan Industries, Inc. v. Nelson*, the court overturned a trial court's failure to consider evidence of an oral modification on the grounds that the contract prohibited subsequent oral modifications.[46] *Nelson* involved an employment contract in which the written contract was subsequently modified by oral agreement because the employer "was having financial difficulties."[47] The employment contract stated that no "modification of this agreement . . . shall be valid unless in writing and duly executed by the party to be charged therewith . . . ."[48] At trial, the employee sought to testify that he "was told that if he wished to stay with the company . . . his pay would be reduced . . . ."[49] The trial court refused to allow the testimony because the written contract contained a "No Oral Modifications" clause.[50]

---

[37] *Id.*

[38] *Id.* at 608.

[39] *Id.*

[40] *Id.* at 609 (citing Westchester Fire Ins. Co. v. Earle, 33 Mich. 143 (1876)).

[41] *Earle*, 33 Mich. at 153.

[42] *Morrison*, 6 S.W. at 609; Am. Garment Prop., Inc. v. CB Richard Ellis-El Paso, L.L.C., 155 S.W.3d 431, 435 (Tex. App.—El Paso 2004, no pet.); Robbins v. Warren, 782 S.W.2d 509, 512 (Tex. App.—Houston [1st Dist.] 1989, no writ), Mar-Lan Indus., Inc. v. Nelson, 635 S.W.2d 853, 855 (Tex. App.—El Paso 1982, no writ).

[43] *Am. Garment Prop., Inc.*, 155 S.W.3d at 435.

[44] *Id.* (citations omitted).

[45] *See id.*

[46] *Mar-Lan Indus. Inc*., 635 S.W.2d at 854–55.

[47] *Id.* at 854.

[48] *Id.* at 855.

[49] *Id.*

[50] *Id.*

In its ruling, the Texas Court of Appeals stated that the trial court was in error in refusing to allow the testimony about the oral modification.[51] The court relied upon previous Texas law as well as secondary legal sources. Quoting American Jurisprudence, the court stated that:

> [a] person who has agreed that he will contract only by writing does not thereby preclude himself from making a parol bargain to change his agreement. There can be no more force in an agreement in writing not to agree by parol than in a parol agreement not to agree in writing, and every agreement of that kind is ended by the new one which contradicts it. Such a stipulation in the original contract may become inoperative because of modification or rescission, waiver or estoppel, or an independent contract.[52]

Because the evidence of the subsequent oral agreement was wrongfully excluded by the trial court, the court ruled that the case had to be remanded for a new trial.[53]

This case is indicative of how Texas courts routinely treat "No Oral Modification" clauses. If the statute of frauds does not apply, your clients could be left wondering why their lawyer did not inform them that oral modifications were not binding.

C. What This Means for Your Clients

Complex commercial agreements continue to include "No Oral Modification" clauses despite their general legal irrelevance. The rule under Texas law is clear: unless the law requires an agreement to be in writing, any "No Oral Modification" clause included therein will not be honored in the event that the agreement is subsequently orally modified.[54] Transactional lawyers should be aware of this and advise clients accordingly. Failure to recognize the ineffectiveness of such clauses could provide the client with a false sense of security.

For instance, clients could assume that "No Oral Modification" clauses operate as protective cloaks, mechanisms that allow clients to talk freely and informally about the terms of an agreement with no fear that discussions could lead to a modification until they are reduced to writing. Under the law, that assumption is false.

Thus, it is important to advise and inform clients that "No Oral Modification" clauses offer very little, if any, protection and should not be relied upon in any way. In essence, "No Oral Modification" clauses should be looked at in the same way as a shiny new sports car that does not have an engine; just because it looks nice does not mean it works.

IV. How Strong is Your Contract's Reliance Disclaimer? How *Schlumberger Technology Co. v. Swanson* and Its Progeny Can Help Your Clients

Contracts often contain provisions, typically referred to as reliance disclaimers or merger clauses, that state that, when executing a contract, the parties did not rely on any statements prior to the making of the agreement. These provisions contain language such as "no promise or representation of any kind has been made to me by the parties hereby

---

[51] *Id.*

[52] *Id.* (quoting 17 AM. JUR. 2D *Contracts* § 467 (1964)).

[53] *Id.* at 855–56.

[54] *See, e.g., Robbins*, 782 S.W.2d at 512.

released"[55] or the "[party] acknowledges that it has not relied in any manner on any warranties, representations and/or guarantees . . . ."[56] It is important for transactional lawyers to understand how courts will apply and interpret reliance disclaimers when and if litigation arises. As the law stands, simply having reliance disclaimers in a contract does not necessarily mean that the courts will uphold them.

For your clients, it is imperative that reliance disclaimers be binding. If not, parties could be exposed to potential fraudulent inducement claims, among other things. It is necessary to understand how courts view these clauses so that your clients are properly protected when they enter into agreements. The landmark *Schlumberger* case and its progeny provide guidance to transactional lawyers that can help them draft reliance disclaimers that courts will uphold in the event litigation follows.

A. *Schlumberger*

In 1997, the Supreme Court of Texas analyzed an issue important to transactional lawyers: can a disclaimer of reliance clause in a release preclude a fraudulent inducement claim?[57] Under the landmark case of *Schlumberger Technology Corp. v. Swanson*, it can, depending on how the release is drafted and the circumstances of the negotiation.[58]

1. *The Facts*

The facts of *Schlumberger* revolve around a diamond mine off of the shore of South Africa. In that case, John and George Swanson (the "Swansons") were brothers whose family had been in the mining industry for decades.[59] The Swansons entered into agreement with SEDCO, Inc. in which the Swansons obtained the right to purchase five percent of shares to mine diamonds.[60] After entering this deal, Schlumberger acquired SEDCO and negotiated a joint venture agreement to mine the diamonds with other companies.[61]

After Schlumberger purchased SEDCO, the Swansons "became concerned about rumors that Schlumberger was going to stop funding its share or withdraw from the joint venture."[62] The Swansons were specifically concerned about how the joint venture would affect the Swanson's interests in the mine.[63] As a result of their concern, the Swansons obtained legal counsel.[64]

Schlumberger, as the Swansons suspected, began negotiating for its withdrawal from the joint venture.[65] During its negotiations to withdraw from the joint venture, Schlumberger began telling the Swansons "that the sea diamond project was neither technologically feasible

---

[55] Atlantic Lloyds Ins. Co. v. Butler, 137 S.W.3d 199, 216 (Tex. App.—Houston [1st Dist.] 2004, pet. denied).

[56] Carousel's Creamery, L.L.C. v. Marble Slab Creamery, Inc., 134 S.W.3d 385, 392 (Tex. App.—Houston [1st Dist.] 2004, pet. dism'd).

[57] 959 S.W.2d 171 (Tex. 1997).

[58] *Id.*

[59] *Id.* at 173.

[60] *Id.*

[61] *Id.*

[62] *Id.* at 174.

[63] *Id.*

[64] *Id.*

[65] *Id.*

nor commercially viable . . . ."[66] The Swansons were "concerned about Schlumberger's assertions" and considered suing Schlumberger.[67]

Eventually, the Swansons elected not to sue and agreed to sell their interest to Schlumberger. As a condition of the sale, the Swansons "relinquished all rights, claims, and interests in the offshore diamond project . . . and released all causes of action against Schlumberger, known or unknown."[68] Importantly, in the release, the Swansons "specifically agreed that they were not relying on any statement or representation . . . and that they had been represented by counsel who had explained the entire contents and legal consequences of the release."[69]

Unfortunately for the Swansons, after selling their interest, Schlumberger sold its interests in the joint venture for an amount far in excess of what it told the Swansons it could obtain.[70] In response to the sale, the Swansons sued Schlumberger for "fraudulently inducing them to sell their interest at an undervalued price" by making misrepresentations as to the technical and commercial feasibility of the project.[71] In short, the Swansons were arguing that the reliance disclaimer in their contract with Schlumberger should not be binding.

2. *The Court's Decision*

Schlumberger stands for the proposition "that a release that clearly expresses the parties' intent to waive fraudulent inducement claims, or one that disclaims reliance on representations about specific matters in dispute, can preclude a claim of fraudulent inducement."[72] This ruling is a result of Texas law favoring and encouraging "voluntary settlements and orderly dispute resolution."[73] However, under *Schlumberger*, such clauses "will not always bar a fraudulent inducement claim."[74] In fact, in *Schlumberger* the court explicitly refused to adopt a *per se* rule to that effect.[75]

The court held that the release in *Schlumberger* was effective to bar a fraudulent inducement claim against Schlumberger. To come to that conclusion, the court emphasized that "[t]he contract and the circumstances surrounding its formation determine whether the disclaimer of reliance is binding."[76] Thus, the circumstances in the release the Swansons granted to Schlumberger were particularly important.[77]

Several factors surrounding the release in *Schlumberger* persuaded the court to rule that the release barred any claim by the Swansons for fraudulent inducement: 1) presence of counsel, 2) sophistication of the parties involved, 3) awareness of a dispute, and 4) the specific language of the release.[78]

---

[66] *Id.*
[67] *Id.*
[68] *Id.*
[69] *Id.*
[70] *Schlumberger*, 959 S.W.2d at 174.
[71] *Id.*
[72] *Id.* at 181.
[73] *Id.* at 178.
[74] *Id.* at 181.
[75] *Id.* at 178.
[76] *Id.* at 179 (citing Columbia Gas Transmission Corp. v. New Ulm Gas, Ltd., 940 S.W.2d 587, 591 (Tex. 1996)).
[77] *Id.* at 180.
[78] *Id.* at 179–80.

Key to the court's decision was the fact that the Swansons were represented by counsel.[79] The court noted that "[i]n negotiating the release, highly competent and able legal counsel represented both parties and, as we have said above, the parties were dealing at arm's length."[80] The presence of counsel for the Swansons helped to ensure that the Swansons fully understood the effect of their release and that the Swansons were not being taken advantage of by Schlumberger.

The court also noted that the sophistication of the Swansons added further reason for the release to be upheld.[81] The Swansons' family had been in the diamond mining business in South Africa for several decades.[82] The sophistication of the Swansons was further demonstrated when the Swansons "disagreed with Schlumberger about the feasibility and value of the sea-diamond project."[83] The Swansons were "knowledgeable and sophisticated business players" who ignored their instinct about the project.[84] Given their sophistication, it was much more likely that the Swansons understood the risks and effect of their release to Schlumberger.

The court also focused on the fact that, when the release was signed, Schlumberger and Swanson were involved in a dispute, the subject of which was the object of the release.[85] Throughout the negotiation process, the Swansons and Schlumberger quarreled over the value and feasibility of the potential mine.[86] In fact, four days before signing the release, the Swansons "seriously considered suing Schlumberger."[87] As a result, the release was drafted almost directly in response to the dispute with Schlumberger.[88] In the text of the release itself, it stated that "there is considerable doubt, disagreement, dispute and controversy . . ." as to the value of the project.[89] Partially because the release specifically mentioned the subject matter of the dispute, the court ruled that the release barred the Swansons from succeeding on a subsequent fraudulent inducement claim.

The court also focused on the language of the release.[90] The release in *Schlumberger* was remarkably specific as to subject matter and broad as to scope.[91] In it, the Swansons released Schlumberger of liability for all "causes of action of whatsoever nature, or any other legal theory arising out of the circumstances described above, from any and all liability damages of any kind known or unknown, whether in contract or in tort."[92] As indicated by the remarkably broad language in the release and specific description of the subject matter about which the release pertained, the Swansons effectively "unequivocally disclaimed reliance upon representations by Schlumberger about the project's feasibility and value."[93]

---

[79] *Id.* at 180.
[80] *Id.*
[81] *Id.*
[82] *Schlumberger*, 959 S.W.2d at 172.
[83] *Id.* at 180.
[84] *Id.*
[85] *Id.*
[86] *Id.*
[87] *Id.*
[88] *Id.*
[89] *Id.*
[90] *Id.*
[91] *Id.*
[92] *Id.*
[93] *Id.*

As noted above, in *Schlumberger*, the Court emphasized that, when evaluating the effectiveness of a reliance disclaimer, "[t]he contract and the circumstances surrounding its formation determine whether the disclaimer of reliance is binding."[94] Thus, *Schlumberger* confirmed that reliance disclaimers can be upheld by the courts. However, it also emphasized that certain factors, such as presence of counsel, sophistication of the parties, presence of a dispute, and broad release language, should be present for a reliance disclaimer to be upheld. The circumstances of each particular case must be examined to see if the release is binding.

B. Specific Applications of the *Schlumberger* Rule

In its ruling in *Schlumberger*, the Texas Supreme Court indicated the factors and considerations that courts should focus on when deciding whether or not to enforce reliance disclaimers. However, because every case is different—an examination of a sample of specific cases applying the holding in *Schlumberger* is helpful.

1. *Carousel's Creamery, L.L.C. v. Marble Slab Creamery, Inc.*[95]

Marble Slab emphasizes the importance of counsel's presence and specific description of the subject matter disclaimed when drafting reliance disclaimers. In *Marble Slab*, the court ruled that the reliance clause did not bar a claim of negligent misrepresentation.[96] *Marble Slab* involved a disclaimer in association with a franchise agreement that stated that the "franchisee acknowledges that it has not relied in any manner on any warranties, representations and/or guarantees regarding . . ." the agreement.[97] In its ruling, the court focused on the fact that "the parties did not enter into the agreement containing the disclaimer to resolve in ongoing dispute."[98] To the contrary, the parties entered the agreement in *Marble Slab* to begin a relationship rather than end one; the opposite of the situation in *Schlumberger*.[99]

The court also noted that the complaining party in *Marble Slab* "did not retain counsel to negotiate with Marble Slab."[100] Additionally, the parties in *Marble Slab* were not nearly as sophisticated as the parties in *Schlumberger*.[101] In essence, the *Marble Slab* court applied the *Schlumberger* factors and concluded that the negligent misrepresentation claim survived.[102]

2. *Atlantic Lloyds Insurance Company v. Butler*[103]

Butler strongly suggests that transactional lawyers can better protect their clients by using those reliance disclaimer in *Schlumberger* as a template. In *Butler*, the plaintiffs each signed a release that released the defendants "from all existing and future claims."[104] When assessing whether the reliance disclaimers were binding, the court specifically noted that "[t]he language of the disclaimer signed by the plaintiffs in this case tracks the language of the

---

[94] *Schlumberger*, 959 S.W.2d at 179.

[95] 134 S.W.3d 385 (Tex. App.—Houston [1st Dist.] 2004, pet. dism'd).

[96] *Id.* at 393.

[97] *Id.*

[98] *Id.* at 394.

[99] *Id.*

[100] *Id.*

[101] *Id.*

[102] *Id.* at 393.

[103] 137 S.W.3d 199 (Tex. App.—Houston [1st Dist.] 2004, pet. denied).

[104] *Id.* at 216.

disclaimer held to be effective by the Supreme Court in *Schlumberger* . . . ."[105] Additionally, the parties were represented by "highly compensated and able counsel."[106] As a result, the court held that the disclaimer was binding.

Texas courts will be amenable to enforcing reliance disclaimers when at least some of the factors in *Schlumberger* are present. But which factors are most important? For the answer to that question, we look to the 2008 Texas Supreme Court case *Forest Oil Corporation v. McAllen*[107] and 2011 Texas Supreme Court case *Italian Cowboy Partners v. Prudential Insurance Company of America*.[108]

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

In *Forest Oil*, the court clarified its ruling in *Schlumberger* and provided additional guidance to transactional lawyers in drafting enforceable reliance disclaimers. As a result, a discussion of the court's holding is relevant.

1. *Factual Background*

Forest Oil Corporation, the defendant in the original action, "settled a long-running lawsuit over oil and gas royalties and leasehold development with [the plaintiffs,] James McAllen and others with interests in the McAllen Ranch."[109] "The settlement agreement [between the parties] disclaimed reliance 'upon any statement or any representation of any agent of the parties.'"[110] Importantly, the release also reserved the right to arbitrate any further claims.[111]

When the plaintiffs later sued Forest Oil for environmental damage and personal injuries, on grounds unrelated to the release, Forest Oil "sought to compel arbitration under the settlement agreement."[112] In response, the plaintiffs alleged that "the arbitration provision was induced by fraud and [was] thus unenforceable."[113] Even though the reliance agreement was written somewhat generally and the fraudulent inducement claim did not relate directly to the subject matter of the release, the Texas Supreme Court held that the reliance disclaimer was binding.[114]

2. *The Court Refused to Distinguish Schlumberger*

Basing its ruling on *Schlumberger*, the Texas Supreme Court first refuted plaintiffs' attempts to distinguish the case from *Schlumberger*.[115] Plaintiffs' first attempt to distinguish *Schlumberger* asserted that the cases were distinguishable because *Schlumberger* "focuses on representations that were made regarding the underlying agreement's core subject matter" and, in this case, "the litigation that led to the 1999 settlement concerned royalty underpayments and mineral underdevelopment, issues having nothing to do with the environmental and

---

[105] *Id.*

[106] *Id.* at 217.

[107] Forest Oil Corp. v. McAllen, 268 S.W.3d 51 (Tex. 2008).

[108] Italian Cowboy Partners, Ltd. v. Prudential Ins. Co. of Am., 341 S.W.3d 323 (Tex. 2011).

[109] *Forest Oil Corp.,* 268 S.W.3d at 53.

[110] *Id.* at 54.

[111] *Id.*

[112] *Id.* at 54.

[113] *Id.* at 55.

[114] *Id.* at 61.

[115] *Id.* at 57.

personal-injury torts that sparked the current litigation and were excepted from the settlement agreement."[116] In essence, the plaintiffs argued that the reliance disclaimer was unenforceable because the alleged misrepresentations "did not concern known disputed matters."[117]

However, the court was not swayed by this distinction. It held that reliance disclaimers in which parties agree to "settle present disputes and arbitrate future ones" need not be narrowly tailored to specific disputes to be enforceable. When the plaintiffs argued that "the settled dispute [in *Schlumberger*] was the only dispute" and that the agreed-to disclaimer was insufficiently specific to be applied to this context, the court remained unswayed, stating that "[a]n all-embracing disclaimer of any and all representations, as here, shows the parties' clear intent."[118] Importantly, the court stated that a "once and for all" release could "constitute an *additional* factor urging rejection of fraud-based claims.

After concluding that the plaintiffs' dispute-based distinctions were meritless, the court examined the specific language of the release and an argument that fraudulent inducement "is essentially a meeting-of-the-minds argument."[119] On both counts, the court ruled that the reliance disclaimer was binding.[120]

As can be seen from some of the case illustrations above, thematic among *Schlumberger*'s progeny is an uneven focus on the *Schlumberger* factors courts use to evaluate reliance disclaimers. This left lawyers asking "Which factors matter most?"

3. *The Court Clarifies Schlumberger*

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

(1) the terms of the contract were negotiated, rather than boilerplate, and during negotiations the parties specifically discussed the issue which has become the topic of the subsequent dispute;
(2) the complaining party was represented by counsel;
(3) the parties dealt with each other in an arm's length transaction;
(4) the parties were knowledgeable in business matters; and
(5) the release language was clear.[121]

The court then noted that the above factors, those which were most relevant in *Schlumberger*, were present in the instant case.[122] Therefore, the disclaimer release was binding.[123]

D. *Italian Cowboy Partners*: A Demonstration of the Limits of *Schlumberger*

In 2011, the Texas Supreme Court again spoke on the effectiveness of reliance disclaimer clauses.[124] This time, the court found that a clause did not effectively disclaim

---

[116] *Id.*
[117] *Id.*
[118] *Id.* at 58.
[119] *Id.* at 59–60.
[120] *Id.*
[121] *Id.* at 60.
[122] *Id.*
[123] *Id.* It should be noted that, in *Forest Oil*, the court refused to adopt a *per se* test. *Id.* According to the court, context is always important. *Id.*; *see also Italian Cowboy Partners,* 341 S.W.3d at 333.

reliance. In this case, a restaurant tenant and its owners sued the landlord and property manager for fraud.[125] The landlord claimed that language in the contract disclaimed the restaurant's reliance on its representations. The provision at issue was a simple merger clause that stated, "Tenant acknowledges that neither Landlord nor Landlord's agents, employees, or contractors have made any representations or promises with respect to the Site, the Shopping Center, or this Lease except as expressly set forth herein."[126]

The court affirmed its analysis in *Schlumberger* and *Forest Oil*, but distinguished these cases based primarily on the different contract language. Whereas in these previous cases, the parties had expressly disclaimed *reliance* on representations, here the parties had merely disclaimed the *fact* that no other representations were made.[127] The court emphasized that parties "***must use clear and unequivocal language***," ***even when the parties are sophisticated and*** "***represented by able attorneys***."[128] In fact, the court explained that it would only look to the other *Forest Oil* factors *if* there was a clear and unequivocal "disclaimer-of-reliance clause."[129] The court also made explicit that "merger clauses, without an expressed clear and unequivocal intent to disclaim reliance or waive claims for fraudulent inducement, have never had the effect of precluding claims for fraudulent inducement."[130]

In addition, the court demonstrated its continued interest in examining the context of the contract at issue. The court took note that the agreement here was "the initiation of a business relationship," rather than the conclusion of one. In such circumstances, parties should be "all the more clear and unequivocal in effectively disclaiming reliance and precluding a claim for fraudulent inducement . . . ."[131]

Transactional lawyers should utilize the court's clarification of *Schlumberger* in *Forest Oil*, and its limits as defined in *Italian Cowboy Partners*, as guidance when negotiating and drafting reliance disclaimers. *Forest Oil* clarified that, while the *Schlumberger* court focused on several different factors, there are five that are most important. *Italian Cowboy* further demonstrated that clear and unambiguous contract language is the most important factor. In particular, the language must expressly reflect an intent to disclaim reliance on any outside representations in order to be effective, even if other factors weigh in favor of enforcement. While the circumstances will always be relevant, by following the court's guidance in *Forest Oil* and *Italian Cowboy* and drafting clear, explicit reliance disclaimers that track the language in *Schlumberger* and take into account the *Forest Oil* factors, transactional lawyers will be able to better protect their clients.

V. Mandatory Arbitration Provisions: Are They Right for Your Clients?

Arbitration clauses have become a staple of complex agreements. Such clauses mandate that, should a dispute arise, the parties must seek binding arbitration rather than litigate the dispute in court. Many transactional attorneys view these as a favorable provision to be included where possible. But is arbitration really better than litigation? The answer is not always yes. The following discussion analyzes some of the benefits and drawbacks of arbitration. The purpose is not to argue that arbitration is not a viable alternative to litigation;

---

[124] *Italian Cowboy Partners*, 341 S.W.3d at 335.
[125] *Id.* at 330.
[126] *Id.* at 328.
[127] *Id.* at 335.
[128] *Id.* at 336.
[129] *Id.* at 337 n.8.
[130] *Italian Cowboy Partners*, 341 S.W.3d at 334.
[131] *Id.* at 335 (citing *Forest Oil*, 268 S.W.3d at 61).

rather, it is to inform transactional lawyers that various factors should be considered before including such a provision.

Arbitration is generally a more private, informal process than litigation and allows parties to agree regarding the process they will use to resolve their disputes.[132] These clauses originally arose because, as litigation became increasingly complex with the advent of a modern world, the inefficiencies of litigation were exacerbated, which caused congestion and delays in the courts.[133]

In an effort to stem the tide of the increasing costs associated with the trial and the discovery process in litigation, many of your clients and potential clients have included arbitration clauses in their agreements with others. However, as legal scholars have noted, many lawyers do not have a full understanding of the arbitration process.[134] Because arbitration clauses are becoming more prevalent in complex transactions and because the decision to include an arbitration clause can have significant ramifications, it is important that transactional attorneys drafting agreements understand this issue.

A. Some Benefits of Arbitration

1. *Privacy*

Some clients simply do not want disputes to be aired in a public setting. Traditional litigation is public in many different ways. Absent some sort of protective order, the public will have access to pleadings and any filings with the court. The public will also be able to attend any court hearing and the trial itself.

Often the public nature of traditional litigation is an insignificant issue. However, depending on the client, the nature of the client's business, the nature of the types of claims likely to arise, and other factors, the ability to maintain some privacy may be an important objective.

Arbitration can provide your clients with at least some form of privacy in the dispute resolution process. The public will generally not have any right of access to the filings made or the hearing itself. As an added and related benefit, because of the private nature of the proceedings, arbitration can also prevent the public from learning how many disputes a particular party is involved in.

Of course, arbitration cannot guarantee privacy. For example, the opposing party may disclose unfavorable information to the public. However, arbitration provides at least some protection for litigants who wish to maintain their privacy.

2. *Finality*

Traditional litigation often has several different phases that can last for a considerable period of time. Once a trial occurs and a final judgment is rendered by the trial court, that "final" judgment is subject to any appeals filed by the parties. The appellate process can be lengthy and can even last longer than the trial itself. This lack of finality can be frustrating to clients.

---

[132] Rogge Dunn, *Arbitration v. Litigation: It's No Contest*, TEXAS LAWYER (June 1997).

[133] *Id.*

[134] Celeste M. Hammond, *The (PRE) (AS) summed "Consent" of Commercial Binding Arbitration Contracts: An Empirical Study of Attitudes and Expectations of Transactional Lawyers*, 36 J. MARSHALL L. REV. 589, 625 (2003).

Arbitration offers more finality. Absent some agreements in the arbitration clause itself, arbitration awards are not appealable. While arbitration awards need to be confirmed in a trial court to assist with enforcement of the award, the grounds on which a trial court can refuse to confirm an award are very limited.[135]

For example, in Texas, courts can only vacate arbitration awards in situations where a party's rights are obviously and severely prejudiced, such as where the award was obtained by fraud, the arbitrators engage in corruption or willful misbehavior, or the arbitrators refused to hear relevant evidence.[136] Accordingly, arbitration can provide your clients with some assurance that the decision made by the arbitrators will stand.

3. *Cost*

Arbitration can be a method to control certain costs associated with litigation. For example, litigation generally allows attorneys "wide latitude" in determining whom to depose in the course of litigating a matter.[137] Thus, litigators can depose dozens of witnesses in the course of a single case. On the contrary, arbitrators will generally allow for few, if any, depositions.[138] More importantly, when cost savings is a goal, as it almost always is, "fishing expeditions" are disfavored in arbitration, which allows for production of only the documents most relevant to the issues, rather than tangentially related documents that have questionable probative value.[139]

B. Some Potential Downsides of Arbitration

1. *Arbitration Costs Can Be Monumental*

Cost-effectiveness is often cited as the primary benefit of the arbitration process. However, it is important for transactional lawyers to keep in mind that arbitration is not always cheaper than litigation. Especially where clients and their businesses are particularly sophisticated, it is possible for the costs associated with arbitration to meet or exceed those in litigation.

One reason for this is that arbitrators are expensive. Arbitrators often charge thousands of dollars for a day's work. While the fees for arbitrators vary, generally the cost of the arbitrator will increase with the complexity of the dispute. Thus, in sophisticated cases that require an arbitrator to have technical expertise, the arbitrator's fees will likely be high.

As logic would dictate, the costs can become even more burdensome if an arbitration clause allows for a panel of arbitrators. Paying three arbitrators is obviously more expensive than paying one.

---

[135] 9 U.S.C. § 10 (2006) (stating grounds where arbitration award can be vacated under the Federal Arbitration Act); TEX. CIV. PRAC. & REM. CODE ANN. § 171.088 (West 2011) (stating grounds where arbitration award can be vacated under the Texas Arbitration Act).

[136] *Id.*

[137] TEX. CIV. PRAC. & REM. CODE ANN. § 171.050 (West 2011).

[138] *See* Charles J. Moxley, Jr., *Discovery in Commercial Arbitration: How Arbitrators Think*, 63-OCT DISP. RESOL. J., 36, 37 (2008).

[139] *See* Moxley, *supra* note 138, at 39.

As noted above, arbitration can be a less expensive alternative to litigation.[140] This can be true partly because arbitration generally restricts the scope of discovery. However, even the discovery costs associated with arbitration can be formidable. In complex cases, where extensive discovery in arbitration is necessary, the cost effectiveness of the arbitration process can quickly disappear.

It is important for your clients to realize that the "limited" discovery procedures that arbitration generally applies are sometimes extended to litigation-like procedures that can be just as expensive as litigation.[141] In the case of "exceptional circumstances," courts have permitted formal discovery.[142] Moreover, the Federal Arbitration Act and most arbitral rules give arbitrators significant discretion over discovery decisions; arbitrators therefore may choose to allow for extensive, costly discovery for any number of reasons: to effectuate the parties' agreement, to make sure the parties have a fair opportunity to make their case, or to avoid upsetting the parties.[143] In those cases, the costs of discovery can approach those in litigation.[144]

While generally less expensive, arbitration is not necessarily the cheaper alternative to litigation. Depending on the sophistication of the client and complexity of the dispute, the costs of arbitration can meet or exceed those in litigation. Unlike judges, arbitrators need to be paid by the parties. But, like judges, arbitrators can and do allow for extensive discovery procedures in complex arbitration proceedings. Accordingly, it is important that transactional lawyers and their clients recognize that arbitration is not always the most efficient dispute resolution alternative, if extensive discovery will be unavoidable to resolve the dispute. Moreover, if arbitration is chosen for its potential for cost savings, it will be essential to select an arbitrator who will enforce these objectives of the arbitral process in favor of streamlined discovery.

2. *Finality – the Double-Edged Sword*

As mentioned above, arbitration offers parties the benefit of being final and not subject to years of appeals. However, there is always a losing party, and that party may wish to challenge the arbitrator's award. As discussed, contrary to litigation, that challenge is usually unavailable in arbitration.

In fact, an arbitrator's decision will not be vacated by the court, even if the arbitrator fails to correctly apply the law.[145] Mistakes of law are not grounds for vacating an arbitration award.[146] That arbitrators do not need to abide by the law is impliedly acknowledged by statute. According to section 171.090 of the Texas Civil Practice and Remedies Code, an arbitrator's award will not be vacated even if "the relief granted by the arbitrators could not or would not be granted by a court of law or equity."[147] As stated succinctly in a law review

---

[140] *See, e.g.,* Dunn*, supra* note 132, at 161.

[141] Wendy Ho, *Discovery in Commercial Arbitration Proceedings*, 34 HOUS. L. REV. 199, 211–12 (1997).

[142] *Id.*

[143] *See* Ho, *supra* note 141, at 213–14. ("Parties and arbitrators . . . have begun to seek and approve extensive discovery procedures in arbitration proceedings" given arbitrators' "great discretion" over discovery rules); Thomas J. Stipanowich, *Arbitration and Choice: Taking Charge of the "New Litigation" (Symposium Keynote Presentation)*, 7 DEPAUL BUS. & COM. L.J. 383, 393 (2009) ("Arbitrators, intent upon striking a balance between court-like due process and efficiency, may be reluctant to push parties to limit" requests for litigation-style extensive discovery).

[144] *See generally* Stipanowich, *supra* note 143.

[145] Crossmark, Inc. v. Hazar, 124 S.W.3d 422, 429 (Tex. App.—Dallas 2004, pet. denied).

[146] *Id.*; *see also* TEX. CIV. PRAC. & REM. CODE § 171.088 (West 2011).

[147] TEX. CIV. PRAC. & REM. CODE § 171.090.

article by Stephen J. Ware, "[a]n agreement to arbitrate is, in effect, an agreement to comply with the arbitrator's decision whether or not the arbitrator applies the law."[148]

Therefore, while the finality of the arbitration process can be beneficial to parties, it can also be detrimental. Especially where the law is incorrectly applied, parties will seek to vacate the arbitrator's award. However, that remedy is generally not available. Thus, it is important for transactional lawyers to inform their clients that arbitration's finality is a double-edged sword. The winner is happy, but the loser is without further remedy.

C. Determining What Claims Are Arbitrable

Arbitration clauses are customizable by the parties. In other words, the parties to an arbitration clause have the ability to determine which claims will be subject to arbitration if a dispute arises.

When negotiating and drafting arbitration clauses for their clients, transactional lawyers should keep in mind that a party will not be able to successfully seek arbitration unless that party proves that the dispute in question is within the scope of the arbitration clause between the parties.[149] The scope of arbitration clauses, like any other provision in an agreement, is interpreted in accordance with traditional contract principles.[150]

As a result, transactional lawyers and their clients can and should determine which claims will be subjected to arbitration when drafting an agreement. Because parties must agree to the scope of the arbitration clause for the agreement to be binding, parties to an agreement have the ability to be specific as to the parties and types of claims that can be subjected to arbitration under an agreement's arbitration clause.

Of course, the opposite is also true. Arbitration clauses can be written broadly so that virtually all disputes with any connection to the agreement or transaction in question will be subject to arbitration. Broadly-drafted arbitration clauses can even create a presumption that the dispute in question is subject to arbitration.[151] Moreover, even a clause that is ambiguous as to scope is likely to be interpreted broadly; once a court has found an arbitration clause to be valid, it will resolve any doubts as to the agreement's scope "in favor of arbitration."[152]

Of course, drafting arbitration clauses broadly could subject your clients to arbitration proceedings for unexpected claims. For instance, in *Satre v. Dommert*, the Texas Court of Appeals in Beaumont interpreted a broadly written arbitration agreement between an investor and a certified financial planner.[153] The clause in question read as follows:

> **Arbitration and Dispute Resolution:** (a) In a dispute or controversy, either arising in the future or in existence now, between me and you . . . we agree to first endeavor to settle the dispute in an amicable manner by mediation . . .

---

[148] Stephen J. Ware, *Default Rules from Mandatory Rules: Privatizing Law Through Arbitration*, 83 MINN. L. REV. 703, 712 (1999).

[149] *In re* Oakwood Mobile Homes, 987 S.W.2d 571, 573 (Tex. 1999).

[150] *See* J.M. Davidson, Inc. v. Webster, 128 S.W.3d 223, 227 (Tex. 2003).

[151] Am. Realty Trust, Inc. v. JDN Real Estate-McKinney, L.P., 74 S.W.3d 527, 531 (Tex. App.—Dallas 2002, pet. denied).

[152] Ellis v. Schlimmer, 337 S.W.3d 860, 862 (Tex. 2011).

[153] 184 S.W.3d 893 (Tex. App.—Beaumont 2006, no pet.).

> . Thereafter, any unsettled dispute or controversy will be resolved by arbitration . . . .[154]

As with all exercises in contractual interpretation, the court focused on the plain language of the agreement.[155] Because of the broad language of the provision, the court held that it could subject "any unsettled dispute or controversy" to arbitration, including but not limited to "inappropriate investments, misrepresentation, breach of fiduciary duty, violation of federal securities law, and [even] negligence."[156]

The law surrounding arbitration proceedings offers transactional lawyers the unique ability to customize the scope of the arbitration clauses that they draft and negotiate for their clients, if they do so clearly. Because every client has specific needs, it is important to keep in mind that a broadly written arbitration clause is not right for every client. Often, clients can benefit from specificity. Arbitration allows transactional lawyers to provide that service.

D. Selecting Your Arbitrator

Arbitration also offers transactional lawyers and their clients the unique ability to choose the arbitrator or the method of selecting an arbitrator that will preside over any future disputes that may arise.[157] Parties in litigation, especially defendants, cannot choose which judge will hear their case. However, parties to an arbitration agreement can outline the method of arbitrator selection in their agreements.[158] Parties can draft an arbitration agreement to specify a particular arbitrator, group of arbitrators or arbitration organization, such as AAA or JAMS, to ensure that fully qualified arbitrators are appointed.[159]

The ability to agree to the method by which an arbitrator can be appointed or the particular arbitrator(s) to be appointed offers the potential additional benefit of cost-savings. Parties concerned about the potential expense of arbitration can agree that an arbitrator cannot be selected if his or her rates exceed a certain amount. Alternatively, parties can agree that only one arbitrator will preside over disputes rather than a panel. Such specificity as to the arbitrators that can be appointed can offer your clients significant savings.

VI. Conclusion

In many ways, transactional lawyers are a client's first line of defense against disputes. It is the transactional lawyer, and not the litigator, who can give advice as well as negotiate and draft an agreement to best protect the client.

Advising clients about the importance of document preservation and the unenforceability of "No Oral Modification" clauses can prevent a client from incurring

---

[154] *Id.* at 896.

[155] *Id.* at 900.

[156] *Id.*

[157] *See, e.g.,* TEX. CIV. PRAC. & REM. CODE § 171.041(a) (West 2011); 9 U.S.C. § 5 (2006).

[158] *See also In re* Serv. Corp. Intern., 355 S.W.3d 655, 659 (Tex. 2011) (Texas Supreme Court upheld provision under which AAA would select an arbitrator in the event the parties could not agree on one); Myer v. Americo Life, Inc., 371 S.W.3d 537, 540 (Tex. App.—Dallas 2012, pet. filed) (Arbitration agreement required each appointed arbitrator to meet the requirements of the American Arbitration Association (AAA) by providing that the arbitration proceedings would be conducted in accordance with the commercial arbitration rules of the AAA). In the event the method of appointment in the arbitration agreement cannot be followed, the court will appoint the arbitrator(s). TEX. CIV. PRAC. & REM. CODE § 171.041(a); 9 U.S.C. § 5.

[159] *See also In re Serv. Corp. Intern.,* 355 S.W.3d at 659; *Myer v. Americo Life, Inc.,* 371 S.W.3d at 540; *see also* TEX. CIV. PRAC. & REM. CODE 171.041(a); 9 U.S.C. § 5.

sanctions or unknowingly modifying an agreement. Furthermore, drafting reliance disclaimers in accordance with *Schlumberger*'s guidance and drafting arbitration clauses to meet a client's needs can protect a client from future fraud claims and unnecessary expense. With the concepts discussed in this paper, transactional lawyers are hopefully better able to inform and protect their clients.

THE DEVELOPMENT OF THE TEXAS NON-COMPETE: A TORTURED HISTORY

Charles M.R. Vethan*

TABLE OF CONTENTS

*Charles Vethan is the Managing Shareholder of the Vethan Law Firm, P.C., rated AV Pre-Eminent by Martindale Hubbel and Board Certified in Commercial Law and Consumer Law by the Texas Board of Legal Specialization. The Firm's practice focuses on commercial, employment, and intellectual property law.

I. INTRODUCTION

A recent article in the New York Times reported the State of Texas hands out more incentives than any other state; around $19 billion a year, to lure the most dynamic businesses in the United States to the Lone Star State.[1] The governor of Texas stated that "Facebook, eBay, Apple – all of those within the last two years have announced major expansion in Texas . . . . They're coming because it is given, it is covenant, in the boardrooms across America, that our tax structure, regulatory climate and legal environment are very positive to those businesses."[2] Although Texas offers tax incentives and a favorable business climate, high tech businesses may have, in the past, understandably been reluctant to relocate to Texas because of the prior anemic protection granted to businesses in the arena of non-competes. These businesses, one assumes, have no interest in training their best and brightest today, only to have them become competitors tomorrow.

The development of the non-compete covenant body of law in Texas, especially within the past five years, has addressed many concerns that businesses could have with the enforcement of non-competes. The dual prongs of *Sheshunoff Management Services v. Johnson*[3] and *Marsh USA v. Cook*,[4] addressed fully in this article, have provided some stability to the important business and legal issue of non-compete enforcement in the state of Texas.

Confidential information, and the access to confidential information, has never been more important as it is in noncompete litigation. Businesses involved in high-tech, engineering, and specialized service sectors necessarily seek to employ individuals with specialized skills, who may often utilize a company's confidential information and trade secrets. Indeed, in order for these businesses to maintain a competitive advantage in the marketplace, employees must have access to their employer's confidential information and trade secrets. Specifically, companies that hire specialists and provide unfettered access to confidential and proprietary information seek covenants from their employees to limit the likely market effect if an employee begins working for himself or herself or a competitor, targeting the former employer's customers. Texas law has, out of necessity, adapted to the needs of the specialized business sector. In doing so, however, it could be argued that Texas has now adopted different noncompete standards for the professional versus blue collar or non-management employees.

The tension between the Texas Legislature, the interpretation by courts of Texas statutes, and employers' goal to preserve confidential information has escalated as more businesses attempt to block today's service managers from becoming tomorrow's competitors. Examining the historic development and application by courts of covenants not to compete, from *Light* to present jurisprudence necessarily set the stage for *Sheshunoff* and *Marsh.*

Texas jurisprudence has gone through a tortured evolution regarding non-competes. Prior to the culmination of *Marsh USA*, practitioners could not provide a clear expectation to businesses as to what a Texas court would do. The history of non-compete law is analyzed in this article to provide the judicial and legislative context that brought Texas to where it is. The road traveled, by courts and our Texas Legislature, however, was not smooth, and *Marsh* still leaves

---

[1] Louise Story, *Lines Blur as Texas Gives Industries a Bonanza*, N.Y. TIMES, Dec. 2, 2012.

[2] *Id*. at A18.

[3] Alex Sheshunoff Mgmt. Servs., L.P. v. Johnson, 209 S.W.3d 644 (Tex. 2006).

[4] Marsh USA Inc. v. Cook, 354 S.W.3d 764 (Tex. 2011).

many unanswered questions, especially as to the type of consideration required to substantiate a noncompete.

When examining the Texas noncompete law, every analysis must begin with *Light v. Centel Cellular Co. of Texas*.[5] It may be argued that, in deciding *Light*, the Texas Supreme Court sought to modify the statutory language of section 15.50 *et seq.* of the Texas Business and Commerce Code (Covenant Not to Compete Act). In fact, the Covenant Not to Compete Act allows the court, even upon finding a covenant not to compete is too broad, to modify the covenant, decide upon a reasonable time and a reasonable geographic limitation, and yet still validate the contract. This is called "blue-lining." Nevertheless, the *Light* majority applied a contract litmus test to determine whether covenants not to compete would be enforceable.

In *Light*, the Texas Supreme Court sidestepped the presumption of enforcement of noncompetes in section 15.51 of the Covenant Not to Compete Act and considered whether consideration is a must to be given in exchange for a contemporaneous covenant not to compete. The Texas Supreme Court argued that consideration from the employer, to form a bilateral contract, must concurrently and independently exist to support a covenant not to compete. In holding this way, the Texas Supreme Court went beyond the requirements of the statute. The original language of the Covenant Not to Compete Act merely stated that if the covenant not to compete is "ancillary to . . . an otherwise enforceable agreement," supported by independent valuable consideration, and contains reasonable limits as to time and geography, the covenant must be enforced.[6]

This article traces the development of Texas law with respect to the covenant not to compete, from the initial common-law holding, to the Covenants Not to Compete Act contained in the Texas Business and Commerce Code, the famous footnote in *Light*, the uncertainties created by *Sheshunoff*[7] and *Mann Frankfort*[8] and, finally, to the Texas Supreme Court's recent decision in *Marsh*.[9] One may finally conclude, at least at the time this article was written, notwithstanding the apparent preference for protecting companies involved in providing products and services involving the use of confidential and proprietary information, courts continue to differentially enforce covenants not to compete. That being the case, an employee who did not have access to confidential and proprietary information need not navigate the same noncompete gamut. Whether a different standard exists for employees who received confidential information and those that did not is beyond the scope of this article. The focus here is on the highly skilled or trusted employee who had access to and was provided with confidential information within a reasonable time of executing a covenant not to compete with the employer.

A. Evolution of Noncompetes

1. Common-Law Chaos

Prior to 1989, enforcement of covenants not to compete were guided by common law principles. At that time, Texas courts merely examined whether restrictive covenants were

---

[5] Light v. Centel Cellular Co. of Tex., 883 S.W.2d 642 (Tex. 1994).

[6] *See* TEX. BUS. & COM. CODE ANN. § 15.50 (West 2011) (No mention is made of unilateral or bilateral contract provisions).

[7] *Sheshunoff*, 209 S.W.3d 644.

[8] Mann Frankfort Stein & Lipp Advisors, Inc. v. Fielding, 289 S.W.3d 844 (Tex. 2009).

[9] *Marsh*, 354 S.W.3d 764.

reasonable. For example, in *Weatherford Oil Tool Co. v. Campbell*, the Texas Supreme Court articulated that:

> An agreement on the part of an employee not to compete with his employer after termination of the employment is in restraint of trade and will not be enforced in accordance with its terms unless the same are reasonable. Where the public interest is not directly involved, the test usually stated for determining the validity of the covenant as written is whether it imposes upon the employee any greater restraint than is reasonably necessary to protect the business and good will of the employer.[10]

In addition, the Texas Supreme Court considered geographic and time limitations holding that "[t]he period of time during which the restraint is to last and the territory that is included are important factors to be considered in determining the reasonableness of the agreement."[11] Another important issue in *Weatherford Oil Tool* was the court's requirement that the employer had the burden to prove the restraint was necessary to protect the business and goodwill of the employer.[12]

Weatherford notwithstanding, nearly thirty years later, in the late 1980s, Texas Supreme Court decisions began to take on hesitancy about enforcing noncompete covenants.[13] In what has been characterized as a "bipartisan assault on prior common law," within a twenty-month time frame, the Texas Supreme Court decided four cases that abruptly altered Texas jurisprudence on noncompetes.[14] The cases are addressed below.

a. *Hill*

In *Hill v. Mobile Auto Trim, Inc*.,[15] the Texas Supreme Court added a significant hurdle to the enforceability of noncompetes. *Hill* concerned Mobile Auto Trim's noncompete agreement with former franchisee Joel Hill.[16] After failing to make required franchise payments, Mobile Auto Trim terminated its franchise relationship with Hill. Thereafter, Hill contacted a car dealership for which he had done work as a franchisee, and at which point Mobile Auto Trim sought to enforce the noncompete against Hill. Mobile Auto Trim was granted a temporary injunction preventing Hill from competing. The injunction was appealed to the Texas Supreme Court. The *Hill* court held that:

> In 1982, the Utah Supreme Court refused to enforce a hearing aid distributor's non-competition agreement against a former salesman, setting forth the standard which we adopt today: "[c]ovenants not to compete which are primarily designed to limit competition or restrain the right to engage in a *common calling* are not enforceable."[17]

---

[10] Weatherford Oil Tool Co. v. Campbell, 340 S.W.2d 950, 951 (Tex. 1960).

[11] *Id*.

[12] *See id.* at 952–954.

[13] *See generally*, Jeffrey W. Tayon, *Covenants Not To Compete in Texas: Shifting Sands from Hill to Light*, 3 TEX. INTELL. PROP. L.J. 143, 147 (1995).

[14] *Id.* at 143.

[15] Hill v. Mobile Auto Trim, Inc., 725 S.W.2d 168, 169 (Tex. 1987).

[16] *Id*. at 169.

[17] *Id.* at 172 (citing Robbins v. Finlay, 645 P.2d 623, 627 (Utah 1982) (emphasis added)).

This "common calling" limitation was uncircumscribed, ambiguous, and unprecedented.[18] Certainly, it complicated the enforcement of covenants not to compete. If any salesperson could avoid enforcement of a noncompete by declaring their occupation a "common calling," no business could protect its trade secrets or goodwill. By following the Utah Supreme Court's holding, the Texas Supreme Court significantly departed from Texas common law.

b. *Bergman*

Bergman v. Norris of Houston[19] concerned a Houston hairstyling salon chain that required its employees to sign noncompetes. Four hairstylists left the salon chain and went to work for a local competitor. One of the hairstylists, Diana Aschwege, held a management position. The employer obtained an injunction against the stylist, enforcing the noncompetes. Thereafter, the case was ultimately appealed to the Texas Supreme Court, which overturned the injunction against the employees.[20] In doing so, the court held that "[b]arbering, however labeled, is a common calling. Conferring upon Aschwege the title of manager of a hair salon does nothing to alter that status."[21]

Justice Gonzales, joined by Justice Hill, filed a dissenting and concurring opinion in which he observed:[22]

> Before Aschwege began working for Norris, she had no customers; when she left, she sent notices to 500 customers and now services 400 of those customers. She was the manager of the salon with authority to hire and fire. She attended monthly meetings in which the managers collectively formulated business policy to improve an already well-established and successful business. Norris' legitimate business interest as to Aschwege should be protected.[23]

The dissent highlighted the danger of the majority's holding. As applied to the enforcement of covenants not to compete, an employee in a management position could invoke the "common calling" exception to the enforcement of a noncompete.

Justice Gonzales and Justice Hill's concerns were not unfounded. Taken to its logical conclusion, a manager of a taxicab company could start a competing business next door to a former employer. If the former employer tries to enforce the parties' noncompete, the employee could claim she was engaged in the common calling of driving a cab and that she was not a manager, just a cabbie with some management duties. As can be seen, many businesses could be and most likely were stolen by its managers as a result of this holding.

---

[18] Tayon, *supra* note 13, at 149 ("In addition, the court decided to apply a new standard to covenants not to compete adding a fifth requirement that the promisor not try to restrain a common calling or limit competition.").

[19] Bergman v. Norris of Hous., 734 S.W.2d 673 (Tex. 1987).

[20] *Id.* at 675.

[21] *Id*. at 674.

[22] *Id*. at 675 (Gonzales, J., dissenting and concurring).

[23] *Id.*

c. *DeSantis*

DeSantis v. Wackenhut Corp.[24] concerned Edward DeSantis' noncompete agreement with Wackenhut Corporation, a supplier of security guards. In that case, the Texas Supreme Court held the covenant not to compete was not necessary to protect Wackenhut and hence the covenant failed for want of consideration.[25]

More significantly, the Texas Supreme Court acknowledged that DeSantis could recover under either "a common law cause of action for wrongful issuance of an injunction [or] a violation of the Texas Free Enterprise and Antitrust Act, because enforcement of the covenant constituted an illegal restraint on trade."[26] The court awarded costs and attorney's fees to DeSantis under the Act[27] and remanded the case for damage calculations.[28]

Under this holding, an employer would be wary of enforcing a noncompete agreement, considering the prospect of potential liability for treble damages, costs, and attorney's fees under the Texas Free Enterprise and Antitrust Act of 1983.

d. *Martin*

Martin v. Credit Protection[29] concerned Bruce R. Martin's noncompete agreement with collection agency, Credit Protection Association, Inc. ("CPA") Martin started a competing collection agency and solicited CPA's customers. The trial court enjoined Martin from competing with CPA, finding a protectable interest in CPA's client list. The Texas Supreme Court held:

> "Customer information" is neither special training nor knowledge. Martin was and is a salesman, a "common calling" occupation. We will not restrain the right of any individual to engage in a common calling. Therefore, we reverse the judgment of the court of appeals, dissolve the injunction, and hold the restrictive covenant void.[30]

Martin may have done the most harm to prior Texas common law:

> Though short in length, the fourth case in the quartet was sweeping in breadth, determining salespersons to be engaged in a "common calling" and describing "customer information" as insufficient special training or knowledge to support a covenant not to compete.[31]

---

[24] DeSantis v. Wackenhut Corp., No. C-6617, 1988 Tex. LEXIS 97 (Tex. July 13, 1988), *opinion withdrawn and substituted by DeSantis v. Wackenhut Corp*., 793 S.W.2d 670 (Tex. 1990).

[25] Tayon, *supra* note 13, at 170–71 (citing *DeSantis*, 31 Tex. Sup. Ct. J. at 620).

[26] *Id.* at 171.

[27] *Id*. at 172.

[28] *Id.* (citing *DeSantis*, 31 Tex. Sup. Ct. J. at 622).

[29] Martin v. Credit Protection Ass'n, Inc., No. C-7339, 1988 Tex. LEXIS 91 (Tex. July 13, 1988), *opinion superseded on denial of rehearing by Martin v. Credit Protection Ass'n, Inc*., 793 S.W.2d 667 (Tex. 1990).

[30] *Id*. at *3.

[31] Tayon, *supra* note 13, at 172 (citing *Martin v. Credit Protection Ass'n, Inc*., No. C-7339, 1988 Tex. LEXIS 91 (Tex. July 13, 1988), *opinion superseded on denial of rehearing by Martin v. Credit Protection Ass'n, Inc*., 793 S.W.2d 667 (Tex. 1990)).

Under this holding, a salesperson could steal customers from their previous employer without fear of injunction from a noncompete. After *Hill, Bergman, DeSantis* and *Martin*, the stage was set for the Texas Legislature to codify a set of rules to guide practitioners and businesses in noncompete law. For the most part, the Texas Legislature was successful and provided a reasonably clear guideline on these contentious covenants. The Texas Supreme Court, however, had other plans.

2. Covenants Not to Compete Act

The Covenants Not to Compete Act added sections 15.50 and 15.51 of the Texas Business and Commerce Code.[32] The Act provides that, under section 15.50, a covenant not to compete is enforceable if it:

> (1) is ancillary to an otherwise enforceable agreement but, if the covenant not to compete is executed on a date other than the date on which the underlying agreement is executed, such covenant must be supported by independent valuable consideration; and
>
> (2) contains reasonable limitations as to time, geographical area, and scope of activity to be restrained that do not impose a greater restraint than is necessary to protect the goodwill or other business interest of the promisee.[33]

The sponsor of the amendments, Senator Whitmire, said:

> It is generally held that these covenants, in appropriate circumstances, encourage greater investment in the development of trade secrets and goodwill employee training, provide contracting parties with a means to effectively and efficiently allocate various risks, allow the freer transfer of property interests, and in certain circumstances, provide the only effective remedy for the protection of trade secrets and good will.
>
> Recent Texas Supreme Court cases (notably *Hill v. Mobile Auto Trim, Inc.*, and *DeSantis v. Wackenhut Corp.*), however, have severely restricted the enforceability of these covenants in franchise and employment settings and raised questions about their use in other previously acceptable circumstances.[34]

Through additional enactments, the Texas Legislature sought to codify guidelines for the enforceability of noncompetes and curtail the narrowing stance taken by the Texas Supreme Court.

---

[32] Act of May 25, 1989, 71st Leg., R.S., ch. 1193, § 1, secs. 15.50 & 15.51, 1989 Tex. Gen. Laws 4852 (codified at TEX. BUS. & COM. CODE ANN. §§ 15.50 & 15.51 (West 2011)).

[33] *Id.*

[34] Tayon, *supra* note 13, at 179 (citing Senate Comm. on Econ. Dev., Bill Analysis, Tex. S.B. 946, 71st Leg., R.S. (1989)).

3. The Texas Supreme Court Responds to the Act

a. *DeSantis* revisited

On June 6, 1990, the Texas Supreme Court withdrew its July 13, 1988 *DeSantis* opinion and issued a new one.[35] The court did not apply the new statute, holding:

> The obvious threshold issue which this recent legislation presents is whether it may affect litigation regarding the rights of parties to an agreement not to compete which commenced before the statute was enacted. We find it unnecessary, however, to resolve this issue in this case because we conclude that the result in this case would not be affected by the statute.[36]

Concerning the agreement between DeSantis and Wackenhut, the court reached the same conclusion as its original *DeSantis* decision. The Texas Supreme Court held that "Wackenhut has not shown that DeSantis' agreement not to compete is necessary to protect any legitimate business interest, or that the necessity of such protection outweighs the hardship of that agreement on DeSantis, we conclude that *the agreement is unreasonable and therefore unenforceable.*"[37] The application of the common law, in lieu of the new statute, revealed the court's stubbornness in recognizing the legislature's effort to make noncompetes more enforceable.

Still, the court reversed its prior holding, and found that damages were not recoverable against Wackenhut under the Texas Free Enterprise and Antitrust Act.[38] Removing this cause of action against employers seeking injunctive relief was the first new step in the direction of deference to noncompetes.

The court also retreated from the "common calling" test previously set it out in *Hill* and *Bergman*:

> In deciding whether an ancillary agreement not to compete is reasonable, the court should focus on the need to protect a legitimate interest of the promisee and the hardship of such protection on the promisor and the public. The nature of the promisor's job—whether it is a common calling—may sometimes factor into the determination of reasonableness, but it is not the primary focus of inquiry. The results in *Hill* and *Bergman* would have been the same irrespective of whether the promisors in those cases had been engaged in common callings. Moreover, the Legislature has now rejected common calling as a test for the reasonableness of noncompetition agreements. *See* TEX. BUS. & COM. CODE ANN. §§ 15.50–15.51 (Vernon Supp. 1990). Accordingly, we do not apply "common calling."[39]

---

[35] DeSantis v. Wackenhut Corp., 793 S.W.2d 670, 685 (Tex. 1990), *replacing withdrawn opinion of DeSantis v. Wackenhut Corp.*, No. C-6617, 1988 Tex. LEXIS 97 (Tex. July 13, 1988).

[36] *Id*.

[37] *Id*. at 684 (emphasis added).

[38] *See* Tayon, *supra* note 13, at 187–88.

[39] *DeSantis*, 793 S.W.2d at 683.

b. *Martin* revisited

Martin,[40] decided on the same day the court abandoned the "common calling" exception in *DeSantis*, applied an even more stringent enforceability requirement to noncompetes.[41] The court held that "[s]ince an employment-at-will relationship is not binding upon either the employee or the employer and either may terminate the relationship at any time; continuation of an employment-at-will relationship does not constitute independent valuable consideration to support the covenant."[42] Although the Covenant Not to Compete Act was written to be retroactive, the Texas Supreme Court ignored it, holding "section 15.50(1) would not require a result in this case different from the one we reach today."[43]

This holding required "independent valuable consideration" in order for a noncompete to be enforceable. The court held:

> Although "customer information" is neither special training nor knowledge which may constitute independent valuable consideration, business goodwill, trade secrets, and other confidential or proprietary information (including "customer information") are legitimate interests which may be protected in an otherwise enforceable covenant not to compete.[44]

Hence, under the *Martin* decision, customer information cannot serve as the "independent valuable consideration." This is so, notwithstanding the foreseeability that a business could possess such an extensive database of customer information with unlimited access such information an essential part of a promotion to management. Such a case would run afoul of *Martin*'s holding.

Martin marked a major shift from the court invalidating noncompetes that infringed on "common callings" to the court now attacking noncompetes for want of consideration.

c. *Travel Masters*

Travel Masters, Inc. v. Star Tours, Inc.[45] expanded the holding of *Martin* to apply not only to covenants not to compete entered into after employment-at-will, but also to covenants not to compete entered into *contemporaneously* with the start of employment at will. The court explained:

> The only difference between this case and *Martin* is that [the employee] executed the covenant not to compete contemporaneously with the inception of her employment while the *Martin* covenant was executed three years after Martin began employment.[46]

The court refused to enforce noncompetes in at-will employment:

---

[40] Martin v. Credit Protection Ass'n, Inc., 793 S.W.2d 667 (Tex. 1990).

[41] *See* Tayon, *supra* note 13, at 188–91.

[42] *Martin*, 793 S.W.2d at 670.

[43] *Id.* at 669 n.1.

[44] *Id.* at 670 n.3 (citing *DeSantis*, 793 S.W.2d at 682).

[45] Travel Masters, Inc. v. Star Tours, Inc., 827 S.W.2d 830 (Tex. 1991).

[46] *Id.* at 832.

> Because employment-at-will is not binding upon either the employee or the employer and is not an otherwise enforceable agreement, we conclude that a covenant not to compete executed either at the inception of or during an employment-at-will relationship cannot be ancillary to an otherwise enforceable agreement and is unenforceable as a matter of law. Since [employee's] covenant not to compete is not ancillary to an otherwise enforceable agreement, we hold that the covenant not to compete is an unreasonable restraint of trade and unenforceable on grounds of public policy.[47]

This holding hindered the enforceability of any noncompete in Texas. Under *Travel Masters*, the Texas Supreme Court challenged the enforceability of any noncompete regardless of whether the noncompete was reasonable. This decision would not go unanswered by the Texas Legislature.

4. 1993 Amendments

In 1993, the Texas Legislature amended the Covenants Not to Compete Act to clarify that covenants not to compete also apply to at-will employment and that the statute supersedes the common law.[48] Section 15.52 was added providing:

> The criteria for enforceability of a covenant not to compete provided by Section 15.50 of this code and the procedures and remedies in an action to enforce a covenant not to compete provided by Section 15.51 of this code are exclusive and preempt any other criteria for enforceability of a covenant not to compete or procedures and remedies in an action to enforce a covenant not to compete under common law or otherwise.[49]

The Legislature's will, as contained in this statute was meant to preempt the common law.

The Legislature further eliminated the language previously contained in section 15.50 which stated that "if the covenant not to compete is executed on a date other than the date on which the underlying agreement is executed, such covenant must be supported by independent valuable consideration . . . ."[50] The legislature added section 15.50(a), "Notwithstanding Section 15.05 of this code, and subject to any applicable provision of Subsection (b), a covenant not to compete is enforceable if it is *ancillary to or part of an otherwise enforceable agreement at the time the agreement is made* . . ."[51] This language, intended by the Legislature to clarify enforceability, would instead, further complicate the enforcement of noncompete covenants.

5. *Light*

Light v. Centel Cellular Co. of Texas[52] may be remembered by future legal scholars of Texas jurisprudence as the wayward footnote which unleashed the floodgates of litigation.

---

[47] *Id.* at 833.

[48] *See* Tayon, *supra* note 13, at 220.

[49] TEX. BUS. & COM. CODE ANN. § 15.52 (West 2011).

[50] TEX. BUS. & COM. CODE ANN. § 15.50 (West Supp. 1993) (amended 2009).

[51] TEX. BUS. & COM. CODE ANN. § 15.50(a) (West 2011) (emphasis added).

[52] Light v. Centel Cellular Co. of Tex., 883 S.W.2d 642 (Tex. 1994).

Light addressed the requirement that "a covenant not to compete is enforceable if it is ancillary to or part of an otherwise enforceable agreement at the time the agreement is made."[53] In 1985, United TeleSpectrum, Inc. hired Debbie Light to sell pagers. In 1987, she was required to execute a new agreement, including a noncompete, in order to keep her job.[54] She resigned in 1988, and sued United's successor-in-interest, Centel Cellular Co., for release from the noncompete.

The Texas Supreme Court in *Light* held that the underlying agreement must be enforceable at the time it is made in order for the noncompete agreement to be enforceable. The court reasoned that an employer's promise to share confidential information with an employee is illusory because an employer could terminate the at-will employment and avoid ever sharing the confidential information.

Thus, the noncompete agreement in *Light*, according to the Texas Supreme Court, represented a unilateral contract that could be accepted by actually supplying the employee with confidential information, but was not provided at the time the noncompete was executed. The court reasoned that this unilateral contract was enforceable at the time of the performance, not at the time the agreement is made. As such, the employer could only seek performance from Light at the time confidential information was provided. The contract was unilateral because the employer, solely, had the right and ability to trigger a performance obligation by the employee, when the employer chose to perform. Until the employer performed by providing confidential information, it could not demand a reciprocal performance by the employee (abiding by the noncompete). "But such unilateral contract, since it could be accepted only by future performance, could not support a covenant not to compete inasmuch as it was not an 'otherwise enforceable agreement at the time the agreement is made' as required by § 15.50."[55] Again, the Texas Supreme Court embarked on an adventurous holding devoid of precedent and alien to the language of the Act.

Justice Hightower wrote in his short concurrence, "I join the court's judgment in this cause. I continue to believe that an at will employment "relationship" or "contract" may not be "an otherwise enforceable agreement." If the employment is "at will," it is not an otherwise enforceable agreement."[56]

This decision imposed limitations on enforcement of noncompetes in Texas. For more than a decade, the employee had a better than even chance of limiting the terms of a covenant not to compete or having it struck as a naked restraint of trade. The Texas Supreme Court focused on the fact the *Light* contract was a unilateral contract, and, as such, could not be an "otherwise enforceable agreement" within the parameters of section 15.50 of the Texas Business and Commerce Code. Why? The fact of the matter is that a unilateral contract, inasmuch as a bilateral agreement is supported by performance, not merely a promise.

a. Unilateral Contracts

Under basic contract law, a unilateral contract is formed by performance. An example of a unilateral contract is:

---

[53] TEX. BUS. & COM. CODE ANN. § 15.50(a) (West 2011).

[54] *Light*, 883 S.W.2d at 643.

[55] *Id*. at 645 n.6.

[56] *Id*. at 648.

> If A says to B, "If you walk across the Brooklyn Bridge I will pay you $100," A has made a promise but has not asked B for a return promise. A has asked B to perform, not a commitment to perform. A has thus made an offer looking to a unilateral contract. B cannot accept this offer by promising to walk the bridge. B must accept, if at all, by performing the act. Because no return promise is requested, at no point is B bound to perform. If B does perform, a contract involving two parties is created, but the contract is classified as unilateral because only one party is ever under an obligation.[57]

Under *Light*, an employer's promise to provide an employee with confidential information in exchange for an employee's noncompete fails to form an enforceable contract. "[A unilateral] contract is completed by the promisee's performing the act or acts called for, not by such promisee making any reciprocal promise or promises."[58] The employer's promise cannot make the contract enforceable. Only the performance completes the contract and makes it enforceable.

6. Unraveling *Light*

a. *Sheshunoff*

Sheshunoff shut the door on noncompetes for employees in sensitive positions within a company. *Alex Sheshunoff Management Services, L.P. v. Johnson* undid the holding of *Light* as to whether a unilateral contract made enforceable by performance could comply with section 15.50.[59] *Sheshunoff* concerned a noncompete signed by Kenneth Johnson as part of a promotion within Alex Sheshunoff Management Services. The agreement included the following:

> To assist Employee in the performance of his/her duties, Employer agrees to provide to Employee, special training regarding Employer's business methods and access to certain confidential and proprietary information and materials belonging to Employer, its affiliates, and to third parties, including but not limited to, customers and prospects of the Employer who have furnished such information and materials to Employer under obligations of confidentiality.

Johnson left the company to work for a competitor and was promptly sued by his former employer, Sheshunoff. Johnson argued the noncompete was unenforceable under the holding of *Light*.

The Texas Supreme Court analyzed the language of section 15.50, ignored *Light*, altered Texas jurisprudence, and still had the audacity to hold that *Light* was not overturned. The court reasoned, "Simply reading the text, the clause 'at the time the agreement is made' can modify either 'otherwise enforceable agreement' or 'ancillary to or part of.'"[60] The court held that the "at the time the agreement is made" clause modified only the "ancillary to or part of" language. Therefore, the agreement need not be enforceable at the time the agreement is made. The *Sheshunoff* decision allows a unilateral contract to fulfill the statute's requirements

---

[57] JOHN D. CALAMARI & JOSEPH M. PERILLO, THE LAW OF CONTRACTS § 2-10(a) (4th ed. 1998).

[58] Shirey v. Albright, 404 S.W.2d 152, 156 (Tex. App.—Corpus Christi 1966, writ ref'd n.r.e.).

[59] Alex Sheshunoff Mgmt. Servs., L.P. v. Johnson, 209 S.W.3d 644, 650–51 (Tex. 2006).

[60] *Id.* at 651.

provided that at the time the agreement was made, it was ancillary to or part of an otherwise enforceable agreement.

i. Jefferson's Concurrence

Chief Justice Jefferson filed a concurrence, which was joined by Justice O'Neill and Justice Medina. Jefferson expressed concern that an employer could have an employee sign a noncompete, fail to provide any confidential information, then just before the employee left, provide confidential information.[61] The Chief Justice wrote:

> The Court's holding permits an employer to enforce a non-compete covenant months or even years after the employee signed it, as long as the employer eventually fulfills its side of the bargain. That sort of delay is inconsistent with clear statutory language that the covenant must be enforceable "at the time the agreement is made." While I agree with the Court that "at the time" does not require an instantaneous exchange of consideration, neither does the statute permit the employer's promise to hang in the air, indefinitely, until it "becomes enforceable" by performance. Rather, consistent with *Light* and with the statute, I would hold that the employer's exchange of consideration must occur within a reasonable time after the agreement is made. Because that condition was satisfied on this record, I concur in the judgment.[62]

Jefferson also criticized the court's interpretation of the phrase "ancillary to or part of." Jefferson wrote:

> A plain reading of the statute, however, establishes that the phrase "at the time the agreement is made" either refers solely to "otherwise enforceable agreement" or to both "otherwise enforceable agreement" and "ancillary to or part of"—but in no event to "ancillary to or part of" alone.[63]

Chief Justice Jefferson's "plain reading" is in direct conflict with the court's holding. He cites the "doctrine of last antecedent." The doctrine dictates that "a qualifying phrase in a statute or the Constitution must be confined to the words and phrases immediately preceding it to which it may, without impairing the meaning of the sentence, be applied."[64]

Further, the Chief Justice argues that "[The court's holding] would permit an employer's illusory promise to bind its employee to the covenant even if, at the time the covenant is signed, the employer never intended to perform, and even when the employer's performance is deferred so long that one cannot say the enforceable agreement and covenant are part of the same transaction."[65]

---

[61] *Sheshunoff*, 209 S.W.3d at 662 ("After today, an employer may easily refrain from sharing trade secrets or other specialized technical knowledge with an employee for a substantial period of time after the covenant is signed, only to quickly perform once the employee indicates an intention to leave his current job for the employer's competitor. *See Light*, 883 S.W.2d at 645 & n. 5 (discussing the example of an employer's promise to raise wages). Thus, an employer may now legitimately restrain trade merely by performing a previously illusory promise, thereby converting an unenforceable unilateral contract into a binding commitment at the last minute. We should not encourage such one-sided gamesmanship.").

[62] *Id*. at 657–58.

[63] *Id*. at 662.

[64] *Id*. at 662 (citing Spradlin v. Jim Walter Homes, Inc., 34 S.W.3d 578, 580–81 (Tex. 2000)).

[65] *Id*. at 662.

ii. Wainwright's Concurrence

Justice Wainwright's concurrence[66] further criticized *Light*. Wainwright wrote:

> In *Light*, the Court explained that "if an employer gives an employee confidential and proprietary information or trade secrets in exchange for the employee's promise not to disclose them, and the parties enter into a covenant not to compete, the covenant is ancillary to an otherwise enforceable agreement . . . ." I agree with this statement. However, *Light* erected two additional requirements to enforce a noncompete. For a covenant not to compete to be "ancillary to or part of" the confidentiality agreement, the consideration given by the employer for the confidentiality agreement "must give rise to the employer's interest in restraining the employee from competing," and the noncompete "must be designed to enforce the employee's consideration or return promise" not to disclose confidential information. I would disapprove of these court-made requirements.[67]

Wainwright believed that a confidentiality agreement could be the "otherwise enforceable agreement" to which the noncompete is ancillary. Justice Wainwright went on to note that continuing employment is sufficient consideration to enforce an arbitration agreement.[68] Similarly, in Wainwright's view, a confidentiality agreement becomes enforceable when an employee merely continues to work. Wainwright criticized the need for additional consideration to enforce a confidentiality agreement when the court "recognized long ago that a fiduciary duty precluded employees from misuse or misappropriation of such property."[69] Under Wainwright's concurrence, although the noncompete may be unenforceable on its face, the confidentiality agreement is enforceable and serves as the otherwise enforceable agreement.[70] Thus, the confidential agreement makes the noncompete enforceable.

b. *Mann Frankfort*

Mann Frankfort opened the door further for the viability of noncompetes. This discussion takes the position of presumed consideration.[71] While, the holding of *Mann Frankfort v. Fielding* may have expanded the enforceability of covenants not to compete, unfortunately, there are no markers against which this rule may be consistently applied. Recall, the employers in *Light* and *Sheshunoff* each promised to provide their employee with confidential information. In return, the employee agreed to be bound by a noncompete agreement. But, this was not the case in *Mann Frankfort*. Therein, and although, the employee, Brendan Fielding, promised not to disclose confidential information, he received no express return promise from his employer, Mann Frankfort. The Texas Supreme Court held, "[w]hen the nature of the work the employee is hired to perform requires confidential

---

[66] *Id.* at 664.

[67] *Id*. at 664 (citation omitted).

[68] *Id*. at 665 (citing *In re* Dallas Peterbilt, Ltd., L.L.P., 196 S.W.3d 161, 163 (Tex. 2006)).

[69] *Id*. at 665 (citing Hyde Corp. v. Huffines, 314 S.W.2d 763, 775 (Tex. 1958)).

[70] *Id*. at 666 ("Both the confidentiality agreement and the noncompete are part of Johnson's employment agreement. I would hold that the covenant not to compete is enforceable on the ground that it is ancillary to the otherwise enforceable confidentiality agreement.").

[71] *See* Mann Frankfort Stein & Lipp Advisors, Inc. v. Fielding, 289 S.W.3d 844, 852 (Tex. 2009).

information to be provided for the work to be performed by the employee, the employer impliedly promises confidential information will be provided."[72]

The court's holding is a *non-sequitur*. The Texas Supreme Court seems to state that an employer would have an employee agree not to disclose confidential information, only if the employer plans on sharing confidential information with the employee.

The same problems of consideration and illusory promises still abound under this holding. Under *Sheshunoff*, an employer could enforce a noncompete by performing its promise. Under *Mann Frankfort*, an employer is not even required to make that promise.

Therefore, the pendulum has swung the other way with an employee justifiably hesitant to limit her ability to work by signing a noncompete. As a result, an employee may find it important to know exactly what specialized training and access to knowledge her employer will provide. Even if the promise to provide such information is illusory, it may be illustrative of what may be provided. With no requirement that a promise be made, an employer can have an employee sign a noncompete with no idea what information will be shared, if any is shared at all.

i. "Nature of the Work"

The holding of *Mann Frankfort* begs the question: does the nature of the work require the employer to provide confidential information and trade secrets to the employee? Texas law recognizes a broad range of protectable trade secrets. Under Texas law:

> A trade secret may consist of any formula, pattern, device or compilation of information which is used in one's business, and which gives him an opportunity to obtain an advantage over competitors who do not know or use it. It may be a formula for a chemical compound, a process of manufacturing, treating or preserving materials, a pattern for a machine or other device, or a list of customers . . . .[73]

However, "[to] be accorded the court's protection the proprietary information must be more than merely of a kind and character encompassed by the definition. It must be information that is not publicly available or readily ascertainable by independent investigation."[74]

Items such as customer lists, pricing information, client information, customer preferences, buyer contacts, market strategies, blueprints, and drawings have all been shown to be trade secrets.[75] In addition, "business goodwill, trade secrets, and other confidential or proprietary information (including 'customer information') are legitimate interests which may

---

[72] *Id.* at 850.

[73] Allan J. Richardson & Assocs., Inc. v. Andrews, 718 S.W.2d 833, 836 (Tex. App.—Houston [14th Dist.] 1986, no writ) (citing Hyde Corp. v. Huffines, 314 S.W.2d 763, 776 (1958) (adopting the definition of "*Trade Secret*" from RESTATEMENT OF TORTS § 757 (1939))).

[74] *Id*. at 837 (citing SCM Corp. v. Triplett Co., 399 S.W.2d 583, 586 (Tex. App.—San Antonio 1966, no writ)).

[75] Am. Precision Vibrator Co. v. Nat'l Air Vibrator Co., 764 S.W.2d 274, 278–79 (Tex. App.—Houston [1st Dist.] 1988, no writ); Miller Paper Co. v. Roberts Paper Co., 901 S.W.2d 593, 601 (Tex. App.—Amarillo 1995, no writ).

be protected in an otherwise enforceable covenant not to compete."[76] The compilation of information may be protectable confidential information.[77]

To determine whether a trade secret exists, Texas courts apply the RESTATEMENT OF TORTS' six-factor test: (1) the extent to which the information is known outside of his business; (2) the extent to which it is known by employees and others involved in his business; (3) the extent of the measures taken by him to guard the secrecy of the information; (4) the value of the information to him and to his competitors; (5) the amount of effort or money expended by him in developing the information; (6) the ease or difficulty with which the information could be properly acquired or duplicated by others.[78]

Given the wide range of interests that may be protected, it is difficult to imagine a job where the "nature of the work" does not require confidential information. Read more broadly, the *Mann Frankfort* decision appears to harken back to a *quasi* "common calling" test that the Texas Supreme Court introduced in *Hill v. Mobile Auto Trim, Inc.* In other words, an employee in a position of common calling—a non-management or blue-collar employee—who is an at-will employee may avoid a covenant not to compete. Alternatively, a management employee or an employee with access to confidential information—who is not a "common calling" employee—must be concerned about this new rule.

ii. Not All Confidential Information is Created Equal

By way of example, consider Eva, a hypothetical employee. Eva works for Widget Co., a Texas company that has secret processes for manufacturing widgets. These trade secrets are the envy of every widget manufacturer in the world. Eva is up for a promotion to plant manager. As plant manager Eva will finally get to know the valuable secret processes that make Widget Co. a success. Widget Co. insists that Eva sign a noncompete before beginning work as plant manager. Eva signs an agreement which provides that, upon the end of her employment, Eva will refrain from competing against Widget Co. within an area of fifty miles for a period of two years. The agreement also provides that Eva will keep confidential any customer lists, pricing information, client information, customer preferences, buyer contacts, market strategies, blueprints, and drawings.

Upon beginning work, Eva is provided with confidential customer lists and information she previously could not access. Eva is disappointed to find out that she is still kept in the dark as to many of the secret manufacturing processes. Under *Sheshunoff* and *Mann Frankfort*, Widget Co. performed its implied promise of providing confidential information. The fact that the nature of the work required confidential information allows Widget Co. to avoid specifics as to what information is to be provided. If Eva were merely packaging widgets on the shop floor, a fungible common calling, she would not be under the strictures of *Mann Frankfort*.

iii. Avoiding the Problem of Presumed Confidentiality

Where there is no express promise by the employer, confidentiality is now presumed in certain cases based upon the nature of the work, and employers are in the precarious

---

[76] Martin v. Credit Protection Ass'n, Inc., 793 S.W.2d 667, 670 n.3 (Tex. 1990).

[77] *See supra* note 68.

[78] *In re* Bass, 113 S.W.3d 735, 739 (Tex. 2003) (citing RESTATEMENT OF TORTS § 757 cmt. b. (1939)).

situation of deciding whether they should later disclose confidential information to an employee because of the uncertainty created by the nature of the work requirement.

The nature of the work requirement is also an escape valve for an employee to avoid the covenant not to compete. Again, suppose Eva, instead of being the plant manager, operates the machine that makes the fabulous widgets. Here, she unavoidably witnesses the secret process of making the widgets, but does the nature of her work *require* confidential information? If not, without the employer's express promise to provide confidential information or trade secrets, a noncompete restricting her ability to work for a competitor would likely be unenforceable. This seems to fly in the face of reasonableness and the intent of the legislature expressed in section 15.50(a).

So, how can business owners and attorneys attempt to avoid the problem of presumed confidentiality that stems from the "nature of the work" requirement? Under a careful reading of *Mann Frankfort*, the court's holding is applied when there is no express promise, but an implied promise from the employer. Thus, when drafting a covenant not to compete, if the employer includes the its express promise to provide confidential information to the employee so that he or she may accomplish any contemplated job duties, the employer may circumvent the problem of presumed confidentiality.

c. *Marsh*

In *Marsh USA Inc. v. Cook*, the Texas Supreme Court further dismantled the holding in *Light* by abrogating the requirement that "the consideration given by the employer in the otherwise enforceable agreement must *give rise* to the employer's interest in restraining the employee from competing"[79] in order to determine what is "ancillary to or part of an otherwise enforceable agreement" under section 15.50.[80] Instead, harkening back to the "reasonableness" standard in *Weatherford Oil Tool*,[81] the court held that the "ancillary to or part of" requirement is satisfied if the consideration given is "reasonably related" to the business interest being protected.[82] Further, the court identified trade secrets, confidential information, and goodwill as business interests worthy of protection.[83]

Importantly, the *Marsh* court eliminated only the first prong of *Light*'s test to determine what is "ancillary to or a part of."[84] Thus, in order to be ancillary, the noncompete provision must still be "designed to enforce the employee's consideration or return promise in the otherwise enforceable agreement."[85] And, now under *Marsh*, the consideration must also be reasonably related to the protected business interest.

---

[79] Light v. Centel Cellular Co. of Tex., 883 S.W.2d 642, 647 (Tex. 1994) (emphasis added).

[80] *See* Marsh USA Inc. v. Cook, 354 S.W.3d 764, 775 (Tex. 2011) ("*Light*'s requirement is contrary to the language of the Act; thwarts the purpose of the Act, which was to expand rather than restrict the enforceability of such covenants; and contradicts the Act's intent to return Texas law on the enforceability of noncompete agreements to the common law prior to *Hill.*").

[81] *See id*. (The court also points out, citing *Sheshunoff,* 209 S.W.3d at 653 (quoting House Research Org., Bill Analysis, Tex. S.B. 946, 71st Leg., R.S. (1989)), that the Covenants Not to Compete Act was intended to codify the common law); *see also Marsh*, 354 S.W.3d at 777 ("The hallmark of enforcement is whether or not the covenant is reasonable.")).

[82] *Id*. at 775.

[83] *Id*.

[84] *Id*. at 773.

[85] Light v. Centel Cellular Co. of Tex., 883 S.W.2d 642, 647 (Tex. 1994).

In *Marsh*, Rex Cook was employed by Marsh USA Inc., an insurance business.[86] Under the company's Incentive and Stock Award Plan in 1996, Cook had a ten-year option to purchase shares of common stock in Marsh's parent company, MMC.[87] In order to exercise the option, Cook had to sign a noncompete, which stipulated that if he left Marsh within three years of exercising the option, for a period of two years he would not solicit or accept business from any of Marsh's clients, prospects, or affiliates, he would not solicit Marsh's employees, and he would maintain the confidentiality of Marsh's confidential information and trade secrets.[88] In 2005, Cook exercised his stock option, and less than three years later he left Marsh and immediately began working for a direct competitor.[89] Marsh sued Cook and the competitor.[90]

The trial court found the noncompete was unenforceable as a matter of law, and, relying on *Light*, the court of appeals affirmed, holding that "the transfer of stock did not give rise to Marsh's interest in restraining Cook from competing."[91]

After detailing the history and policy behind noncompete common law and statutory law in Texas, the court emphasized that the legislature never intended section 15.50(a) include a "give rise" requirement:

> Turning to the "give rise" question, the Legislature did not include a requirement in the Act that the *consideration* for the noncompete must give rise to the interest *in restraining competition with the employer.* Instead, the Legislature required a nexus—that the noncompete be "ancillary to" or "part of" the otherwise enforceable agreement between the parties.[92]

Accordingly, the court found the requirement of a nexus between the covenant not to compete and the interest(s) being protected is satisfied when the noncompete is reasonably related to an interest worthy of protection.[93] While, the court unequivocally expressed its intent to bring the statute in conformity with the common law prior to *Hill* some may question how this new requirement (while doing away with one of *Light*'s requirements) clarified section 15.50(a). Justice Green surely did.

i. Green's Dissent

Justice Green argued back to the *Marsh* majority that the "consideration prong remains an equally crucial inquiry under the Act, and its application is rendered meaningless by the Court's decision to concoct a new, broad definition of 'ancillary or part of' as 'reasonably related to.'"[94] Additionally, Green pointed out that stock options had never been recognized as a valid form of consideration in a noncompete.[95] Pointing out a consequence of

---

[86] Marsh USA Inc. v. Cook, 354 S.W.3d 764, 766 (Tex. 2011).

[87] *Id*. at 766–67.

[88] *Id*.

[89] *Id*. at 767.

[90] *Id*.

[91] *Id*. at 768.

[92] Marsh USA Inc. v. Cook, 354 S.W.3d 764, 775 (Tex. 2011).

[93] *Id*.

[94] *Id*. at 792.

[95] *Id*. at 794.

the court's holding, Green noted, "[i]f any financial incentive that can encourage an employee to create more goodwill can satisfy the consideration prong of the Act, then we might as well ignore the consideration requirement all together. Under the Court's reasoning, a raise, a bonus, or even a salary could support an enforceable covenant."[96] With this minimum threshold, Green, viewing this new standard as unreasonable for the employee, maintained that the court's holding "not only thwarts the legislative intent behind § 15.50, but also contradicts the strong policy goals inherent in Chapter 15, which protect the interests of free trade and a competitive market**.**"[97]

ii. Wainwright's Response to Green

Contrary to Justice Green, Justice Wainwright reiterated that the court's holding helped conform the statute's interpretation with the original intent of the legislature and the common law prior to *Hill*. Moreover, Wainwright pointed out that, while trade secrets, confidential information, or special training are more easily definable than goodwill, "[t]he Act expressly provides that goodwill is an interest worthy of protection, and the common law before that agreed."[98]

7. What Does All This Mean?

Beginning with the pertinent language of the statute, a covenant not to compete is enforceable if:

1) it is ancillary to or part of an otherwise enforceable agreement at the time the agreement is made

2) to the extent that it contains limitations as to time, geographical area, and scope of activity to be restrained that are reasonable and do not impose a greater restraint than is necessary to protect the goodwill or other business interest of the promisee.[99]

Next, one must consider the Texas Supreme Court's interpretation of the first prong since *Light*:

1) Under *Light* and *Marsh*, "ancillary to or part of" means:

a) the covenant must be designed to enforce the employee's consideration or return promise in the otherwise enforceable agreement;[100] and

b) the consideration given by the employer for the noncompete must be reasonably related to a business interest worthy of protection.[101]

2) Under *Sheshunoff*, "at the time the agreement is made" includes:

---

[96] *Id.* at 790.

[97] *Id*. at 795.

[98] Marsh USA Inc. v. Cook, 354 S.W.3d 764, 779 (Tex. 2011).

[99] TEX. BUS. & COM. CODE ANN. § 15.50(a) (West 2011).

[100] Light v. Centel Cellular Co. of Tex., 883 S.W.2d 642, 647 (Tex. 1994).

[101] *Marsh*, 354 S.W.3d at 775.

> A unilateral contract with an at-will employee, which becomes enforceable when the employer performs the promises it made in exchange for the covenant.[102]

3) Under *Mann Frankfort*, in the case when the employer makes no express promises in the noncompete, "an otherwise enforceable agreement" includes:

> An implied promise to provide confidential information when the nature of the work performed by the employee requires the use of confidential information to carry out his or her duties.[103]

B. Effects of Noncompete Law

The decision of the Texas Legislature to make noncompetes more enforceable was designed to make Texas more attractive to businesses. Accordingly, Texas businesses will have comfort knowing, when sharing confidential information with their employees that those employees will be bound by mutually agreed upon noncompete provisions. Whether making noncompetes enforceable will result in more businesses coming to Texas and generating tax revenues is debatable. Certainly, a business with many trade secrets and proprietary information would desire enforceable noncompetes to bind their employees.

From a practical point of view, absent a noncompete provision, an employer may be reluctant to share trade secrets with an employee. After all, an employee who has benefited from special training and knowledge of proprietary information may use those same benefits for or on behalf of the employer's competitor, or the employee may, himself, become a competitor.

Furthermore, the point of noncompete law is to "maintain and promote competition in trade and commerce" in Texas.[104] In order to incentivize businesses to truly compete, businesses must have the assurance they can share confidential information with their employees, and the information shared or specialized skills taught do not end up in the hands of a competitor. Accordingly, as the *Marsh* court detailed, the primary concern of a noncompete provision is contained in the reasonableness of the restrictions upon an employee after the employee is no longer employed:

> The Legislature, presumably recognizing these interests could conflict, crafted the Act to prohibit naked restrictions on employee mobility that impede competition while allowing employers and employees to agree to reasonable restrictions on mobility that are ancillary to or part of a valid contract having a primary purpose that is unrelated to restraining competition between the parties. *See* TEX. BUS. & COM. CODE ANN. §§ 15.05(a), .50(a). By doing so, the Legislature facilitates its stated objective of promoting economic competition in commerce.[105]

Unfortunately, by creating unprecedented limitations on the "ancillary to or part of an otherwise enforceable agreement at the time the agreement is made" requirement under section 15.50(a), the court in *Light* inadvertently undermined the reasonableness requirement

---

[102] Alex Sheshunoff Mgmt. Servs., L.P. v. Johnson, 209 S.W.3d 644, 646 (Tex. 2006).

[103] Mann Frankfort Stein & Lipp Advisors, Inc. v. Fielding, 289 S.W.3d 844, 850 (Tex. 2009).

[104] TEX. BUS. & COM. CODE ANN. § 15.04 (West 2011).

[105] *Marsh*, 354 S.W.3d at 770.

contained in the same sentence of the subsection. Since *Light*, the court has made noble attempts to either abrogate or restrict the requirements set out in *Light*, but in doing so, has created new uncertainties: when is "nature of the work" presumed confidential? Considering that financial incentives are now valid consideration in a noncompete, when is the reasonably related threshold not met in relation to the protected business interest?

Texas's relatively new course correction, leaning towards enforcement of noncompetes, seems to adhere more closely with the Texas Covenants Not to Compete Act. The at-will doctrine, especially as it applies to employees with access to sensitive company information, is not dead, but it is certainly qualified. Similarly, analysis of a noncompete provision is no longer limited to the four corners of the document, or whether the contract was unilateral versus bilateral, but now may consider the underlying duties of an employee, and whether that employee, during the course of his or her employment, received confidential information and trade secrets from the employer. If such information were imparted to the employee, a previously toothless noncompete provision could acquire a litigious ferocity. Additionally, under *Marsh*, the uncertainty as to valid consideration for a noncompete may tempt the floodgates of litigation. Thus, is the present standard of Texas noncompete law, at least as of the time of publication of this article. Moreover, the court's recent holdings may likely invite drastically varying decisions from the bench, especially at the injunction stage. Until the Texas Supreme Court provides reasonable guidance on its various requirements and limitations on noncompetes, there will be unpredictability in enforcement, and increased litigation. That simply is something many Texas businesses, large and small, cannot afford.

CONFLICT OF LAWS – DOES A STATE'S WHOLE LAW, INCLUDING THAT STATE'S CONFLICT OF LAWS PRINCIPLES, APPLY TO A CHOICE OF LAW PROVISION IN A CONTRACT?

By Alanna Beck[*]

IRB-Brasil Resseguros, S.A. v. Inepar Invs., S.A., 20 N.Y.3d 310 (N.Y. 2012).

In December 2012, the Court of Appeals of New York decided that a conflict of laws analysis is not necessary in a case where parties expressly agree, by a choice of law provision in their contract, to have New York law apply.[1] The Court of Appeals applied New York's internal substantive law to a lawsuit filed by IRB-Brasil Resseguros, S.A. ("IRB") seeking interest and principal that were due pursuant to a guarantee contract in which Inepar S.A. Industriaé Construçõpes ("IIC") guaranteed payment on a Euro Medium-Term Note Program (the "Note Program") that was initiated by Inepar Investments, S.A. ("Inepar").[2]

IIC is a Brazilian corporation that owns sixty percent of the common stock of Inepar Energia, who is not a party to this lawsuit.[3] Inepar is a Uruguayan corporation and wholly-owned subsidiary of Inepar Energia.[4] In effect, IIC is a parent corporation of Inepar because it is the majority shareholder of the corporation that wholly owns Inepar.[5] IRB, also a Brazilian corporation, filed this lawsuit in New York to recover unpaid principal and interest from both IIC, as guarantor, and Inepar, as the issuer of the notes.[6]

In September 1996, Inepar initiated a Note Program, under which $30,000,000 in Global Notes were issued by Inepar.[7] These notes had a maturity date in October 2001.[8] The Note Program was governed by a Fiscal Agency Agreement (the "Agreement") among Inepar, IIC, and Chase Manhattan Bank.[9] The choice of law provision in the Agreement stated in part, "[this] Agreement, the Notes, and the Guarantee shall be governed by, and construed in accordance with, the laws of the State of New York, without regard to conflict of laws principles."[10] A separate guarantee contract was signed by IIC to "unconditionally and irrevocably" guarantee payment on the Note Program (the "Guarantee").[11] The Court of Appeals identified that the choice of law provision in the Guarantee provided that "it would be 'governed by and…be construed in accordance with, the laws of the State of New York.'"[12] In this provision, the language that excluded New York's conflict of laws principles was omitted.[13]

---

[*] Alanna Beck is a 2013 J.D. Candidate at South Texas College of Law.

[1] IRB-Brasil Resseguros, S.A. v. Inepar Invs., S.A., 20 N.Y.3d 310, 313 (N.Y. 2012).

[2] *Id.*

[3] IRB-Brasil Resseguros, S.A. v. Inepar Invs., S.A., No. 604448/06, 2009 WL 2421423, at *1 (N.Y. Sup. Ct. July 31, 2009).

[4] *Id.*

[5] *Id.*

[6] *IRB-Brasil Resseguros, S.A.*, 20 N.Y.3d at 313.

[7] *Id.*

[8] *Id.*

[9] *Id.*

[10] *Id.*

[11] *Id.*

[12] *Id.*

[13] *Id.*

At the end of September 1996, IRB purchased $14,000,000 in Global Notes pursuant to the Note Program.[14] From 1997 to 2000, IRB received eight interest payments but never received the payment of the $14,000,000 in principal.[15] IRB commenced this action to recover its principal and unpaid accrued interest from Inepar, the issuer, and IIC, the guarantor of the notes.[16]

IIC argued that it is not liable under the Guarantee, because the Guarantee did not expressly exclude New York's conflict of laws principles, as the Agreement did.[17] IIC contended that as a result of this language being omitted, New York's whole law, which includes New York's conflict of laws principles, should apply.[18] According to IIC, if New York's whole law is applied, then under common law conflict of laws principles the New York court would have to look to Brazilian substantive law to determine whether there was an enforceable contract between the parties.[19] IIC further argued that under Brazilian law there was not an enforceable contract because "the two officers who signed the [G]uarantee lacked actual authority" to enter into the contract.[20]

The Supreme Court of New York, Appellate Division rejected IIC's contention and held that when parties expressly agree to have New York law apply, then New York substantive law will determine whether a third party can enforce a contract that was allegedly executed by a person without actual authority to do so.[21] Under New York law, even if the officers lacked actual authority to enter into the contract, the parties may still be bound to the contract under the doctrines of apparent authority and ratification.[22] In this case, there was no evidence submitted by IRB to support the conclusion that the officers had apparent authority to enter into the contract.[23] Under the doctrine of ratification, the Supreme Court looked to several facts to come to the conclusion that the "transaction was implicitly ratified by IIC."[24] IIC accepted the benefits of the transaction as the parent company of Inepar.[25] The $30,000,000 that Inepar obtained "was used for investments undertaken pursuant to a strategy set by IIC's Administrative Council."[26] Because of IIC's acceptance of the benefits of the transaction, the Supreme Court concluded that IIC ratified the transaction and therefore IRB is entitled to sue on the Guarantee.[27]

The Court of Appeals of New York affirmed the lower court's application of New York substantive law, by relying on sections 5-1401(1) and 5-1402(1) of the New York General Obligations Law, and further stated that the Restatement (Second) of Conflict of Laws supported the same conclusion.[28]

---

[14] *Id.*

[15] *Id.*

[16] *Id.*

[17] *Id.*

[18] *Id.*

[19] *Id.*

[20] IRB-Brasil Resseguros, S.A. v. Inepar Invs., S.A., 922 N.Y.S.2d 308, 310 (N.Y. App. Div. 2011).

[21] *Id.* at 311.

[22] *Id.*

[23] *Id.*

[24] *Id.*

[25] *Id.*

[26] *Id.*

[27] *Id.*

[28] IRB-Brasil Resseguros, S.A. v. Inepar Invs., S.A., 20 N.Y.3d 310, 314–16 (N.Y. 2012).

First, the Court of Appeals discussed the New York General Obligations statutes.[29] Section 5-1401(1) of the General Obligations Law allows parties to a contract, for a transaction amount not less than $250,000, to choose New York law to govern the transaction without the requirement of having a "reasonable relation to [New York]."[30] The Court of Appeals identified the New York Legislature's policy in enacting this statute as preventing the deterrence of parties from choosing New York substantive law by enhancing predictability of applicable governing law, which in turn protects New York's standing as "a commercial and financial center."[31] Section 5-1402(1) of the General Obligations Law allows parties to maintain an action in a New York court if they do not have New York contacts and "(1) engaged in a transaction involving $1,000,000 or more, (2) agreed in their contract to submit to the jurisdiction of New York courts, and (3) chose to apply New York law pursuant to General Obligations Law § 5-1401(1)."[32] Based on these two statutes and the Legislature's policy, the Court of Appeals concluded that the New York substantive law applies to a choice of law provision that meets the requirements of the above statutes and, like the provision in the Guarantee, it is not necessary to expressly exclude New York's conflict of laws principles.[33]

Next, the Court of Appeals stated that the Restatement (Second) of Conflict of Laws also supported the "conclusion that an express exclusion of New York's conflict of law [principles] is unnecessary."[34] Section 187 of the Restatement (Second) of Conflict of Laws states in relevant part, that "[i]n the absence of a contrary indication of intention, the reference [to the law of the state chosen by the parties] is to the local law of the state of the chosen law."[35] The term "local law" is defined in section 4[1] as "the body of standards, principles and rules, exclusive of Conflict of Laws."[36] Based on these sections of the Restatement, because the parties expressly chose to have New York law govern the Guarantee by a choice of law provision in their contract, the Guarantee's validity will be determined under New York substantive law.[37]

Would a Texas court reach the same result under similar facts?

The Court of Appeals of New York first looked to the local statutes to conclude that it had jurisdiction over the parties and that New York substantive law applied to determine whether the Guarantee was enforceable by IRB.[38] Texas has a statute similar to section 5-1401(1) of the New York General Obligations Law, which governs choice of law provisions in big transactions. Chapter 271 of the Texas Business and Commerce Code[39] is the relevant chapter to look to; it applies to "qualified transactions."[40] A "qualified transaction" is one in which the value of the transaction is equal to or exceeds $1,000,000.[41] Under section 271.002, multiple transactions will be considered to be a single transaction if the transactions are substantially similar or related, "are entered into contemporaneously," and "have at least one

---

[29] *Id.*

[30] *Id.* at 314 (quoting N.Y. GEN. OBLIG. LAW § 5-1401(1) (Consol. 1984)).

[31] *Id.*

[32] *Id.* at 315 (quoting N.Y. GEN. OBLIG. LAW § 5-1402(1) (Consol. 1984)).

[33] *Id.* at 315.

[34] *Id.* at 316.

[35] *Id.* (quoting RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187 (1971)).

[36] *Id.* (quoting RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 4(1) (1971)).

[37] *Id.* at 316.

[38] *Id.* at 314–15.

[39] TEX. BUS. & COM. CODE ANN. §§ 271.001–.011 (West 2011).

[40] § 271.001.

[41] *Id.*

common party."[42] Section 271.003 states that "[f]or the purposes of this chapter, a reference to the law of a particular jurisdiction does not include that jurisdiction's conflict-of-laws rules."[43] The statute then addresses different situations in which the law of a "particular jurisdiction" is applied.[44]

The applicable section for a fact pattern similar to the one in *IRB-Brasil Resseguros, S.A*. is section 271.005(a).[45] Under this section, "the law of a particular jurisdiction governs an issue relating to a qualified transaction if: (1) the parties to the transaction agree in writing that the law of that jurisdiction governs the issue, including the validity or enforceability of an agreement relating to the transaction … and (2) the transaction bears a reasonable relation to that jurisdiction."[46]

Section 271.004 offers guidance on determining whether "the transaction bears a reasonable relation to a particular jurisdiction."[47] This section contains a nonexclusive list of examples in which a transaction bears a reasonable relation to a particular jurisdiction.[48] Some relevant examples are: "a party to the transaction is a resident of that jurisdiction," "a party to the transaction has the party's place of business…in that jurisdiction," and "all or part of the subject matter of the transaction is located in that jurisdiction."[49]

In analyzing the facts of *IRB-Brasil Resseguros, S.A*., assuming that the choice of law provision states that Texas law would govern, a Texas court would likely reach a similar conclusion to that of the New York Court of Appeals. Under section 271.002 of the Texas Business and Commerce Code, both the Agreement and the Guarantee, as two substantially related transactions that are entered into contemporaneously and have at least one common party, IIC, would be considered as a single transaction.[50] This transaction meets the threshold requirement of a qualified transaction because the value of the transaction is $30,000,000, which exceeds the $1,000,000 qualified transaction requirement.[51]

After determining that the transaction is a qualified transaction, under section 271.005, Texas substantive law would govern if the parties to the transaction agreed in writing that Texas law governs.[52] This requirement would be met in this hypothetically assumed transaction; in both the Agreement and Guarantee, the parties expressly agree, under these new facts, to have Texas law govern the transaction. The next requirement for Texas substantive law to apply is that the transaction must bear a reasonable relation to Texas.[53] One party to the Agreement in *IRB-Brasil Resseguros, S.A*., was Chase Manhattan Bank as a Fiscal Agent.[54] For this analysis, it will be assumed the Agreement has a Texas-based Fiscal Agent or party. As previously stated, under section 271.002, the Agreement and Guarantee will be considered a single transaction, and this would lead to at least one party to the qualified transaction having

---

[42] § 271.002.

[43] § 271.003.

[44] §§ 271.005–.007.

[45] § 271.005(a).

[46] *Id.*

[47] § 271.004.

[48] *Id.*

[49] § 271.004(b)(1)(A)–(C).

[50] § 271.002.

[51] § 271.001.

[52] § 271.005(a)(1).

[53] § 271.005(a)(2).

[54] IRB-Brasil Resseguros, S.A. v. Inepar Invs., S.A., 20 N.Y.3d 310, 313 (N.Y. 2012).

a residence or principal place of business in Texas.[55] The second requirement under section 271.005(a) would then be satisfied as the transaction would bear a statutorily deemed reasonable relation to Texas.[56] As a result, the law of Texas would govern the transaction, not including Texas conflict of laws principles,[57] regardless of whether it violates a fundamental or public policy of Texas or any other jurisdiction.[58]

Based on the above reasoning, and if a Texas court had jurisdiction to decide a similar case, the Texas court would likely apply Chapter 271 of the Texas Business and Commerce Code to reach a result similar to that of the Court of Appeals of New York. A Texas court would apply Texas substantive law to determine the whether there is an enforceable contract, when a choice of law provision expressly provides for Texas law. This would hold true irrespective of whether the provision expressly excluded the chosen state's conflict of laws principles.

There are a couple of key differences to note between Chapter 271 of the Texas Business and Commerce Code and section 5-1401 of the New York General Obligations Law. First, the New York statute only applies to an agreement where parties select New York law to govern (i.e., the statute is inbound only).[59] Chapter 271 applies when the parties select Texas law or any other state's laws (i.e., the statute is inbound and outbound).[60] Another key difference is the New York statute does not require the transaction to have a reasonable relationship to New York.[61] The Texas statute, on the other hand, does require the transaction to have a reasonable relationship to Texas.[62] Despite having this requirement, the Texas statute is liberal in its list of contacts deemed reasonable.[63]

The Court of Appeals of New York also looked to section 187 of the Restatement (Second) of Conflict of Laws in support of its conclusion.[64] A Texas court also may look to section 187 to reach or support a conclusion to apply Texas substantive law to govern a contract that contains a choice of law provision that expressly provides for Texas law to govern. The Texas Supreme Court, in *Sonat Exploration Co. v. Cudd Pressure Control Inc.*,[65] held that under Texas conflict of laws principles governing contracts, courts should "look to Restatement (Second) of Conflicts of Laws…§ 187 for contracts that contain an express choice of law [provision]."[66] Under a similar analysis as the Court of Appeals of New York, a Texas court would likely reach the conclusion that Texas substantive law (i.e., Texas law excluding its conflict of laws principles) applies when a contract expressly provides for Texas law to govern.[67]

---

[55] § 271.002.

[56] § 271.005(a)(2).

[57] § 271.003.

[58] § 271.005(b).

[59] N.Y. GEN. OBLIG. LAW § 5-1401(1).

[60] TEX. BUS. & COM. CODE ANN. §§ 271.001–.011.

[61] N.Y. GEN. OBLIG. LAW § 5-1401(1).

[62] TEX. BUS. & COM. CODE ANN. § 271.005.

[63] § 271.004.

[64] IRB-Brasil Resseguros, S.A. v. Inepar Invs., S.A., 20 N.Y.3d 310, 316 (N.Y. 2012).

[65] 271 S.W.2d 228 (Tex. 2008).

[66] *Id.* at 231.

[67] Under both Texas and New York law, if section 187 of the Restatement (Second) of Conflict of Laws is applied, part of its test, in subsection (2)(b), is to determine if the transaction "would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issue and which…would be the state of the applicable law in the absence of an effective choice of law by the parties."

Arguably, if a transaction does not meet the minimum dollar requirements of the statute, then the court can look to the Restatement (Second) of Conflict of Laws to reach the same result if a substantial relationship with the chosen state can be established.[68]

The analysis above assumed that a Texas court would have jurisdiction to hear the claims of the parties. The Texas Supreme Court, in *In re AIU Ins. Co.*,[69] addressed the enforceability of a forum selection clause in an insurance policy.[70] Under this case, a Texas court will generally enforce a forum selection clause unless the forum is a "remote alien forum," there is indication that the forum was chosen to discourage claims, or there is fraud or overreaching.[71] Venue selection clauses in Texas are governed by section 15.020 of the Texas Civil Practice and Remedy Code.[72] This section only applies to major transactions,[73] which are those that are "equal to or greater than $1,000,000."[74] Under section 15.020(b), an action will be brought in the selected venue "if the party against whom the action is brought has agreed in writing that a suit arising from the [major] transaction may be brought in that county."[75] This is a way in which a Texas court could have jurisdiction, similar to section 5-1402(1) of the New York's General Obligation Law, which allowed the court in *IRB-Brasil Resseguros, S.A*. to have jurisdiction over IRB's claims.

Inconsistent language within the same document or in different documents within the same transaction inevitably leads to an increased chance for litigation over the meaning of the difference in language. However, with regard to differently worded choice of law provisions (as to whether the chosen state's conflict of laws principles are to be excluded), *IRB-Brasil Resseguros, S.A.* established that a conflict of laws analysis is not necessary where parties expressly agree to have New York law apply.[76] In fact, the Court of Appeals stated that if the parties wish for New York's conflict of law principles to apply they must "expressly designate in their contract" that such principles are to apply.[77] A Texas court having jurisdiction in a similar case would go through a similar statutory or Restatement (Second) of Conflict of Laws analysis, and it would likely reach the same result as New York's Court of Appeals.

---

[68] RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187(2)(a).

[69] *In re* AIU Ins. Co., 148 S.W.3d 109 (Tex. 2004).

[70] *Id.* at 112.

[71] *Id.* at 114.

[72] TEX. CIV. PRAC. & REM. CODE ANN. § 15.020 (West 2011).

[73] § 15.020(e).

[74] § 15.020(a).

[75] § 15.020(b).

[76] IRB-Brasil Resseguros, S.A. v. Inepar Invs., S.A., 20 N.Y.3d 310, 316 (N.Y. 2012).

[77] *Id.*

LIMITED LIABILITY COMPANY LAW – WHETHER A MANAGER OF A MANAGER-MANAGED LIMITED LIABILITY COMPANY BREACHED FIDUCIARY DUTIES UNDER DELAWARE LAW TO THE LIMITED LIABILITY COMPANY AND ITS MEMBERS

By Robert Arthur[*]

Gatz Props., LLC v. Auriga Capital Corp., 59 A.3d 1206 (Del. 2012).

In *Gatz Properties, LLC v. Auriga Capital Corporation*,[1] the Supreme Court of Delaware recently affirmed in a per curiam opinion a decision of the Delaware Court of Chancery, in which the Court of Chancery concluded that the manager of a manager-managed limited liability company (LLC) was subject to liability for damages for breach of fiduciary duty.[2] The Delaware Supreme Court's opinion is significant because it instructs lower courts to disregard the Court of Chancery's conclusion that an LLC's manager owes fiduciary duties under the Delaware LLC statute except to the extent that the parties displace those duties by contract.[3] The Delaware Supreme Court expressly left undecided the issue whether an LLC manager owes fiduciary duties by default under the Delaware LLC statute and stated that the issue "is one about which reasonable minds could differ."[4]

In *Gatz*, William Gatz sought to develop a piece of land owned by the Gatz family in order to build a golf course on it.[5] Acting through Gatz Properties, LLC (Gatz Properties), he joined with Auriga Capital Corp. and other minority investors to form Peconic Bay, LLC (Peconic Bay), a Delaware limited liability company.[6] The Amended and Restated Limited Liability Company Agreement (LLC Agreement) of Peconic Bay designated Gatz Properties as Peconic Bay's manager.[7] William Gatz managed, controlled, and partially owned Gatz Properties, and thus effectively served as manager of Peconic Bay.[8] The Gatz family and their affiliates owned over 85% of the Class A membership interests and over 52% of the Class B membership interests of Peconic Bay.[9]

Gatz Properties leased the family property to Peconic Bay under a long-term ground lease.[10] As contemplated by the LLC Agreement, Peconic Bay entered into a long-term sublease with American Golf Corporation, a national golf course operator.[11] The term of the sublease was thirty-five years, with American Golf having the option to terminate the contract after the tenth year of its operation.[12] American Golf agreed to pay rent starting at $700,000 per year as well as additional rent in the amount of 5% of the revenue from its golf course

---

[*] Robert Arthur is a May 2014 J.D. Candidate at South Texas College of Law in Houston, Texas.

[1] Gatz Props., LLC v. Auriga Capital Corp., 59 A.3d 1206 (Del. 2012).

[2] *Id*. at 1218.

[3] *Id.* (stating "that court's statutory pronouncements must be regarded as dictum without any precedential value").

[4] *Id*. at 1219.

[5] *Id*. at 1208–09.

[6] *Id*. at 1208.

[7] *Id*.

[8] *Id*.

[9] *Id*.

[10] Gatz Props., LLC v. Auriga Capital Corp., 59 A.3d 1206, 1209 (Del. 2012).

[11] *Id*.

[12] *Id*.

operations.[13] American Golf neglected maintenance to the point that the golf course was in extremely poor condition.[14] The golf course's operations were never profitable and, by at least 2005, it became clear that American Golf would exercise its option to terminate the lease in 2010.[15] Aware of the likelihood of termination, Gatz hired an appraiser in 2005 who valued the land at $10.1 million with golf course improvements and $15 million as vacant land available for development.[16]

In August 2007, Matthew Galvin, on behalf of RDC Golf Group, Inc., approached Gatz with an offer to acquire Peconic Bay's long-term lease.[17] Gatz submitted Galvin's offers of $3.75 million and $4.15 million to votes of Peconic Bay's members, but the members rejected each offer.[18] William Carr of Auriga Capital suggested that Gatz ask Galvin if he would be interested in a deal at $6 million.[19] Gatz contacted Galvin and suggested that no further discussions would be fruitful unless Galvin was willing to discuss a number "*well north* of $6 million."[20] Galvin indicated that he may have an interest in proceeding on those terms, but Gatz did not respond to Galvin's requests to negotiate.[21] Despite Galvin's continued interest, Gatz told the minority members of Peconic Bay that negotiations between the parties had broken off with RDC Golf Group's best offer of $4.15 million.[22]

In January 2008, Gatz offered to purchase the interests of Peconic Bay's minority members for an amount equal to the distribution each member would receive if Peconic Bay sold its assets for a cash price of $5.6 million.[23] Under this proposal, the minority members would have received $734,131 for their membership interests in Peconic Bay.[24] Gatz suggested that this amount would be equivalent to selling Peconic Bay's assets for over $6 million since the transaction would not result in closing costs or prepayment penalties that would apply in a sale to a third party.[25] All minority members of Peconic Bay except one rejected Gatz's offer.[26] Because Gatz had conditioned his offer on unanimous acceptance by the minority members, Gatz's offer to purchase did not proceed.[27]

Intent on finding a way to purchase the minority members' interests, Gatz decided to take another approach and get a second appraisal on the property.[28] This time he did not inform the appraiser of American Golf's shortcomings as a course operator, or Galvin's offers and high revenue projections.[29] As a result, the appraiser relied solely on American Golf's financial records and data from comparable golf courses.[30] The appraiser found that the value of the

---

[13] *Id*.
[14] *Id*.
[15] Gatz Props., LLC v. Auriga Capital Corp., 59 A.3d 1206, 1209 (Del. 2012).
[16] *Id*.
[17] *Id*.
[18] *Id.*
[19] *Id*. at 1210.
[20] *Id*. (emphasis added).
[21] *Id*.
[22] Gatz Props., LLC v. Auriga Capital Corp., 59 A.3d 1206, 1210 (Del. 2012).
[23] *Id*.
[24] *Id*.
[25] *Id*.
[26] *Id*.
[27] Gatz Props., LLC v. Auriga Capital Corp., 59 A.3d 1206, 1210 (Del. 2012).
[28] *Id*.
[29] *Id*.
[30] *Id*.

property was somewhere between $2.8 and $3.9 million.[31] Following a second offer to the minority members, Gatz informed the minority members that Peconic Bay would be sold at auction and that Gatz Properties would bid.[32] Gatz retained an auctioneer with experience mainly in bankruptcy court proceedings and that had never auctioned a golf course.[33] The auction was marketed in small-print classified advertisements in general circulation newspapers and a few magazines, online ads and direct mailings.[34] No golf course brokers, managers, or operators were ever contacted.[35] Gatz, on behalf of Gatz Properties, was the only bidder to show up to the auction.[36] He purchased Peconic Bay for $50,000 plus the assumption of the LLC's debt. The minority members of Peconic Bay collectively received $20,985.[37]

The minority members of Peconic Bay sued Gatz and Gatz Properties alleging they breached their contractual duties under the LLC Agreement and breached their fiduciary duties to the LLC and its minority members.[38]

Delaware Court of Chancery. The Court of Chancery began its analysis by interpreting the LLC Agreement.[39] Section 15 of the LLC Agreement provided:

> Neither the Manager nor any other Member shall be entitled to cause the Company to enter into any amendment of any of the Initial Affiliate Agreements which would increase the amounts paid by the Company pursuant thereto, or enter into any additional agreements with affiliates on terms and conditions which are less favorable to the Company than the terms and conditions of similar agreements which could then be entered into with arms-length third parties, without the consent of a majority of the non-affiliated Members (such majority to be deemed to be the holders of 66-2/3% of all Interests which are not held by affiliates of the person or entity that would be a party to the proposed agreement).[40]

The Court of Chancery concluded that Section 15 imposes fiduciary duties in transactions between the LLC and affiliated persons.[41] Specifically, the Court of Chancery reasoned that Section 15 permits Gatz to engage in a self-dealing transaction with the LLC without the approval of the minority members if the price is equivalent to the price that would be negotiated in a transaction with an unrelated third party, i.e., a fair price.[42] According to the court, Section 15 imposes on Gatz the burden of proving that he paid a fair price, determined by a reasonable examination of what a third-party buyer would pay for the Peconic Bay.[43] The Court of Chancery concluded that the entire record, including Gatz's failure to negotiate with an interested good faith buyer, indicates that Gatz failed to meet his burden and therefore breached his fiduciary duties to the LLC and the minority members.[44]

---

[31] *Id*.
[32] Gatz Props., LLC v. Auriga Capital Corp., 59 A.3d 1206, 1211 (Del. 2012).
[33] *Id*.
[34] *Id*.
[35] *Id*.
[36] *Id*. at 1212.
[37] *Id*.
[38] *Id*.
[39] Auriga Capital Corp. v. Gatz Props., LLC, 40 A.3d 839, 849 (Del. Ch. 2012).
[40] *Id*. at 857.
[41] *Id*. at 858.
[42] *Id*.
[43] *Id*.
[44] *Id*.

The Court of Chancery's opinion is significant because it concludes that a manager of a manager-managed LLC owes to the LLC and its members fiduciary duties by default under the Delaware LLC statute, i.e., fiduciary duties that apply except to the extent displaced by contract.[45] The court recognized that the Delaware Limited Liability Company Act does not "plainly state" that LLC managers owe fiduciary duties, but noted that the same is true of the Delaware General Corporation Law, which the Delaware Supreme Court has stated must be "read in concert with equitable fiduciary duties."[46] The Court of Chancery reasoned that the statutory language of the Delaware Limited Liability Company Act is more explicit regarding the application of equitable principles because it states that "the rules of law and equity . . . shall govern."[47] The Delaware Limited Liability Company Act also permits "elimination of default fiduciary duties"[48] in the LLC Agreement, which the Court reasoned would be an unnecessary provision if fiduciary duties did not apply absent their contractual adoption.[49] The Court of Chancery concluded that, by enacting these provisions, the Delaware General Assembly had indicated that "[d]efault fiduciary duties do apply in the LLC context to the extent they are not contractually altered."[50]

Delaware Supreme Court. The Delaware Supreme Court agreed with the Court of Chancery's conclusion that Section 15 of Peconic Bay's LLC Agreement imposes fiduciary duties in transactions between the LLC and affiliated persons.[51] The Delaware Supreme Court reasoned that, although Section 15 does not use the terms "entire fairness" or "fiduciary duties," when "[v]iewed functionally, the quoted language is the contractual equivalent of the entire fairness equitable standard of conduct and judicial review.[52] The Delaware Supreme Court upheld the Court of Chancery's determination that Gatz breached the fiduciary duties contractually adopted by Section 15 of the LLC Agreement.[53]

Although it affirmed the result, the Delaware Supreme Court admonished the Court of Chancery for addressing the issue whether the Delaware LLC statute imposes fiduciary duties by default on LLC managers.[54] The Delaware Supreme Court stated that reaching the "default fiduciary duty issue" was unnecessary, and any statutory pronouncements in the Court of Chancery's opinion pertaining to default fiduciary duties should be "regarded as dictum without any precedential value."[55] Despite a well-reasoned opinion by the Court of Chancery, the Delaware Supreme Court expressly left the issue open, stating that "the merits of the issue whether the LLC statute does—or does not—impose default fiduciary duties is one about which reasonable minds could differ."[56]

---

[45] *Id*. at 851.

[46] *Id*. at 849.

[47] *Id*. (citing DEL. CODE ANN. tit. 6, § 18-1104 (West 1992)).

[48] *Id*. at 851 (citing 74 Del. Laws 275 § 13 (2004)).

[49] *Id*. at 852.

[50] *Id*.

[51] Gatz Props., LLC v. Auriga Capital Corp., 59 A.3d 1206, 1213 (Del. 2012).

[52] *Id*.

[53] *Id*. at 1214.

[54] *Id*. at 1218.

[55] *Id*.

[56] *Id*. at 1219.