

# TEXAS JOURNAL OF BUSINESS LAW

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## CONFIDENTIALITY AGREEMENTS ARE CONTRACTS WITH LONG TEETH

By Byron F. Egan<sup>1</sup>

### I. CONFIDENTIALITY AGREEMENTS AND THEIR EFFECTS ARE EVOLVING

A confidentiality agreement (also sometimes called a non-disclosure agreement or “NDA”) is typically the first stage for the due diligence process in a business combination or joint venture transaction (collectively, “M&A”) as parties generally are reluctant to provide confidential information to the other side without having the protection of an NDA. The target typically proposes its form of NDA,<sup>2</sup> which may provide that it makes no representations regarding any information provided, and a negotiation of the NDA ensues. Some NDAs contain covenants restricting activities of the buyer after receipt of confidential information.<sup>3</sup>

The recent cases discussed below highlight that the possible consequences of an agreement to maintain the confidentiality of information can be far reaching and are evolving. These cases also teach that, in addition to the importance of having contractual provisions sufficient to accomplish the intended objectives, director awareness of the effects of provisions in NDAs their companies enter into can have fiduciary duty implications. Thus, the lessons of these recent cases should be considered by counsel and discussed with the client before an NDA is entered into for a significant transaction.

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Byron F. Egan is a partner of Jackson Walker L.L.P. in Dallas, Texas. Mr. Egan is Senior Vice-Chair and Chair of the Executive Council of the ABA Business Law Section’s Mergers and Acquisitions Committee and former Co-Chair of its Asset Acquisition Agreement Task Force, which published the ABA Model Asset Purchase Agreement with Commentary (2001). Mr. Egan is also Chair of the Texas Business Law Foundation and is former Chairman of the Business Law Section of the State Bar of Texas and of that Section’s Corporation Law Committee.

<sup>2</sup> A seller’s form of confidentiality agreement is attached as Appendix B to Byron F. Egan, *Acquisition Structure Decision Tree*, TexasBarCLE & Bus. Law Section, State Bar of Texas (May 23, 2014), available at <http://images.jw.com/com/publications/1980.pdf>. See also Article 12 of the ABA Model Asset Purchase Agreement (2001) and the Model Confidentiality Agreement accompanying the ABA Model Public Company Merger Agreement (2011).

<sup>3</sup> See, e.g., *Goodrich Capital, L.L.C. v. Vector Capital Corp.*, 11 CIV. 9247 (JSR) (S.D.N.Y. June 26, 2012) (confidentiality agreement permitted use of confidential information solely to explore the contemplated business arrangement and not to minimize broker’s role or avoid payment of its fees; a prospective bidder used information provided about other comparable companies to acquire one of the other companies; broker’s lawsuit against that prospective bidder for breach of contract for misusing confidential information survived motion to dismiss); *In re Del Monte Foods Co. S’holders Litig.*, 25 A.3d 813, 837 (Del. Ch. 2011) (confidentiality agreement restricted bidders from entering into discussions or arrangements with other potential bidders; in temporarily enjoining stockholder vote on merger because target was unduly manipulated by its financial adviser, Delaware Vice Chancellor Laster faulted bidders’ violation of the “no teaming” provision in the confidentiality agreement and the target’s Board for allowing them to do so). See Byron F. Egan, *How Recent Fiduciary Duty Cases Affect Advice to Directors and Officers of Delaware and Texas Corporations* at 268-71 nn.809-11, Univ. of Tex. Sch. of Law 36th Annual Conference on Secs. Regulation and Bus. Law (Feb. 14, 2014), available at <http://images.jw.com/com/publications/1945.pdf>.

## II. NO REPRESENTATIONS

In *RAA Management, LLC v. Savage Sports Holdings, Inc.*,<sup>4</sup> the Delaware Supreme Court held that non-reliance disclaimer language in a confidentiality agreement was effective to bar fraud claims by a prospective buyer. The prospective buyer had been told by seller during early discussions that seller had no significant unrecorded liabilities, but due diligence showed otherwise. The confidentiality agreement provided that seller made no representations regarding any information provided and that buyer could only rely on express representations in a definitive acquisition agreement, which was never signed. The non-reliance provision in the NDA at issue in the *RAA* case provided as follows:

You [RAA] understand and acknowledge that neither the Company [Savage] nor any Company Representative is making any representation or warranty, express or implied, as to the accuracy or completeness of the Evaluation Material or of any other information concerning the Company provided or prepared by or for the Company, and none of the Company nor the Company Representatives, will have any liability to you or any other person resulting from your use of the Evaluation Material or any such other information. Only those representations or warranties that are made to a purchaser in the Sale Agreement when, as and if it is executed, and subject to such limitations and restrictions as may be specified [in] such a Sale Agreement, shall have any legal effect.

After deciding not to pursue a transaction, the buyer sued seller to recover its due diligence and other deal costs. In affirming the Superior Court's dismissal of the buyer's complaint, the Delaware Supreme Court in *RAA* wrote:

Before parties execute an agreement of sale or merger, the potential acquirer engages in due diligence and there are usually extensive precontractual negotiations between the parties. The purpose of a confidentiality agreement is to promote and to facilitate such precontractual negotiations. Non-reliance clauses in a confidentiality agreement are intended to limit or eliminate liability for misrepresentations during the due diligence process. The breadth and scope of the non-reliance clauses in a confidentiality agreement are defined by the parties to such preliminary contracts themselves. In this case, RAA and Savage did that, clearly and unambiguously, in the NDA.

\* \* \*

The efficient operation of capital markets is dependent upon the uniform interpretation and application of the same language in contracts or other documents. The non-reliance and waiver clauses in the NDA preclude the fraud claims asserted by RAA against Savage. Under New York and Delaware law, the reasonable commercial expectations of the parties, as set forth in the non-reliance disclaimer clauses in Paragraph 7 and the waiver provisions in Paragraph 8 of the NDA, must be enforced. Accordingly, the Superior Court properly granted Savage's motion to

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<sup>4</sup> 45 A.3d 107, 119 (Del. 2012).

dismiss RAA's Complaint.

The *RAA* holding was consistent with other cases upholding non-reliance provisions under Delaware law. In *ABRY Partners V, L.P. v. F&W Acquisition LLC*,<sup>5</sup> a stock purchase agreement included a merger clause or a "buyer's promise" that it was not relying upon any representations and warranties not stated in the contract, and the Delaware Chancery Court wrote that such provisions are generally enforceable:

When addressing contracts that were the product of give-and-take between commercial parties who had the ability to walk away freely, this court's jurisprudence has . . . honored clauses in which contracted parties have disclaimed reliance on extra-contractual representations, which prohibits the promising party from reneging on its promise by premising a fraudulent inducement claim on statements of fact it had previously said were neither made to it nor had an effect on it.

\* \* \*

The teaching of this court . . . is that a party cannot promise, in a clear integration clause of a negotiated agreement, that it will not rely on promises and representations outside of the agreement and then shirk its own bargain in favor of a "but we did rely on those other representations" fraudulent inducement claim. The policy basis for this line of cases is, in my view, quite strong. If there is a public policy interest in truthfulness, then that interest applies with more force, not less, to contractual representations of fact. Contractually binding, written representations of fact ought to be the most reliable of representations, and a law intolerant of fraud should abhor parties that make such representations knowing they are false.

\* \* \*

Nonetheless, . . . we have not given effect to so-called merger or integration clauses that do not clearly state that the parties disclaim reliance upon extra-contractual statements. Instead, we have held . . . that murky integration clauses, or standard integration clauses without explicit anti-reliance representations, will not relieve a party of its oral and extra-contractual fraudulent representations. The integration clause must contain "language that . . . can be said to add up to a clear anti-reliance clause by which the plaintiff has contractually promised that it did not rely upon statements outside the contract's four corners in deciding to sign the contract." This approach achieves a sensible balance between fairness and equity—parties can protect themselves against unfounded fraud claims through explicit anti-reliance language. If parties fail to include unambiguous anti-reliance language, they will not be able to escape responsibility for their own fraudulent representations made outside of the agreement's four corners.

In *Abry*, however, the Court allowed a fraud claim to proceed where, notwithstanding a

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<sup>5</sup> 891 A.2d 1032, 1056 (Del. Ch. 2006).

clear anti-reliance provision, the plaintiff alleged that the defendant had intentionally lied within the four corners of the agreement.<sup>6</sup>

In *Pyott-Boone Electronics Inc., etc. v. IRR Trust for Donald L. Fetterolf* Dated December 9, 1997,<sup>7</sup> a diversity action involving the sale of a Virginia business, the disappointed buyer sued for damages for breach of the purchase agreement as well as for related tort claims and claims for breach of the Virginia Securities Act based on information that was furnished to buyer pursuant to a due diligence request months before the purchase agreement was signed. In dismissing the complaint the Court, applying Delaware law pursuant to the agreement's choice of law clause, found that plaintiff's breach of contract claim was founded on an impossibly broad interpretation of a provision to the effect that all representations and warranties in the agreement were correct and did not misstate or omit to state any material fact. The Court stated that "to reach the conclusion that the plaintiff advocates, the warranties contained in [that representation] would effectively encompass every statement any of the defendants ever made to the plaintiff regarding the sale throughout months of negotiations."<sup>8</sup> In construing the provision, the Court was influenced by the purchase agreement's entire agreement provision which provided:

This Agreement, including the Schedules and Exhibits hereto, together with the Confidentiality Agreement constitutes the entire agreement of the parties hereto respecting its subject matter and supersedes all negotiations, preliminary agreements and prior or contemporaneous discussions and understandings of the parties hereto in connection with the subject matter hereof. There are no restrictions, promises, representations, warranties, agreements or undertakings of any party hereto with respect to the transactions contemplated by this Agreement, the Confidentiality Agreement, or the Transaction Documents, other than those set forth herein or therein or in any other document required to be executed and delivered hereunder or thereunder.<sup>9</sup>

The Court held that "[t]he plain language of [the entire agreement provision] states that the parties made no representations beyond those specifically included in the agreement. If the plaintiff wished to rely upon the [information furnished during the due diligence process], it

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<sup>6</sup> *Id.* at 1058-59; see Glenn D. West & W. Benton Lewis, Jr., *Contracting to Avoid Extra-Contractual Liability—Can Your Contractual Deal Ever Really Be the “Entire” Deal?*, 64 BUS. L.W. 999 (Aug. 2009); cf. OverDrive, Inc. v. Baker & Taylor, Inc., No. 5835-CC, 2011 WL 2448209 (Del. Ch. June 17, 2011). The *Onedrive* case arose out of a joint venture agreement providing that "[n]either party is relying on any representations, except those set forth herein, as inducement to execute this Agreement," and in which the plaintiff alleged that defendant intentionally lied about specific provisions in the joint venture agreement by failing to reveal plans to use confidential information received from plaintiff in arrangements with competitors. *Id.* at \*6. In denying defendant's motion to dismiss, Chancellor Chandler wrote that "[u]nder the teaching of *ABRY Partners V, L.P. v. F&W Acquisition LLC*, use of an anti-reliance clause in such a manner is contrary to public policy if it would operate as a shield to exculpate defendant from liability for its own intentional fraud—‘there is little support for the notion that it is efficient to exculpate parties when they lie about the material facts on which a contract is premised.’" *Id.* (quoting *Abry Partners V, L.P.*, 891 A.2d at 1062).

<sup>7</sup> 918 F. Supp. 2d 532 (W.D. Va. 2013).

<sup>8</sup> *Id.* at 538.

<sup>9</sup> *Id.* at 538 n.4.

should have negotiated for its explicit inclusion in the [purchase agreement].”<sup>10</sup> Thus, the Court gave effect to the bargain the parties made as set forth in their contract.

Texas courts have dealt with non-reliance provisions outside of the M&A arena and have imposed conditions to their enforceability not found in Delaware cases. In *Italian Cowboy Partners, Ltd. v. Prudential Ins. Co.*,<sup>11</sup> the Texas Supreme Court held that a merger clause does not waive the right to sue for fraud should a party later discover that the representations it relied upon before signing the contract were fraudulent, unless the clause also disclaims reliance on representations (thus negating an essential element of a claim for fraudulent inducement) and it is insufficient to merely state that promisor has not made any representations or promises except as expressly set forth in the agreement.

*Italian Cowboy* was influential in *Allen v. Devon Energy Holdings, L.L.C. F/K/A Chief Holdings, L.L.C. and Trevor Rees-Jones*,<sup>12</sup> in which Allen alleged that Chief and Trevor Rees-Jones, Chief’s manager and majority owner, fraudulently induced him to redeem his interest two years before the company sold for almost 20 times the redemption sales price to Devon Energy Production Company, L.P. The defense focused on disclaimers and release provisions in the redemption agreement, which it contended barred Allen’s fraud claims by negating reliance or materiality as a matter of law. The Court of Appeals held that the redemption agreement did not bar Allen’s claims, and that fact issues existed as to fraud and the existence of a fiduciary relationship, in reversing the trial court’s summary judgment for the defense and for such purpose assuming the correctness of the facts alleged by Allen below.

Allen and Rees-Jones served together as partners at a prominent Dallas law firm. Allen was an oil and gas transactions lawyer, and Rees-Jones was a bankruptcy lawyer before leaving the firm to go into the oil and gas business. Allen was one of Chief’s early investors, and relied on investment advice from Rees-Jones.

In November 2003, Rees-Jones decided to redeem the minority equity interests in Chief. He sent to the minority members a letter explaining the reasons for and terms of the redemption offer, to which he attached (1) an independent valuation firm’s opinion on Chief’s market value and (2) an appraisal of Chief’s existing gas reserves and future drilling prospects. The valuation report included discounts for the sale of a minority interest and for lack of marketability. The letter also included Rees-Jones’s pessimistic assessment of a number of facts and events that could negatively impact Chief’s value in the future.

The redemption proposal languished for seven months until June 2004 when Rees-Jones notified the minority members that Chief was ready to proceed with the redemption. Three of the minority members (including Allen) accepted the redemption offer, and four others chose to retain their interests. There were positive developments in the Barnett Shale area where Chief operated and within Chief in the seven months between the November 2003 offer and the June 2004 redemption, and Allen asserted that these events, which Allen claimed were not

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<sup>10</sup> *Id.* at 538.

<sup>11</sup> *Italian Cowboy Partners, Ltd. v. Prudential Ins. Co. of Am.*, 341 S.W.3d 323 (Tex. 2011).

<sup>12</sup> *Allen v. Devon Energy Holdings, L.L.C.*, 367 S.W.3d 355 (Tex. App.—Houston [1st Dist.] 2012, pet. granted) (case settled in 2013 while petition pending).

disclosed to him, and would have materially impacted his decision to redeem his interest.

Chief provided Allen with a written redemption agreement for the first time in June 2004, and “insisted” that the contract be signed by the end of the month. The parties did not exchange drafts, and Allen stated that he had only three days to review the agreement before signing because he was on vacation for much of the time.

The redemption agreement contained several release clauses which are discussed below, including an “independent investigation” paragraph, a general “mutual release,” and a merger clause which defendants claimed barred Allen’s fraud claims negating reliance or materiality as a matter of law. The “independent investigation” paragraph provided that (1) Allen based his decision to sell on his independent due diligence, expertise, and the advice of his own engineering and economic consultants; (2) the appraisal and the reserve analysis were estimates and other professionals might provide different estimates; (3) events subsequent to the reports might “have a positive or negative impact on the value” of Chief; (4) Allen was given the opportunity to discuss the reports and obtain any additional information from Chief’s employees as well as the valuation firm and the reserve engineer; and (5) the redemption price was based on the reports regardless of whether those reports reflected the actual value and regardless of any subsequent change in value since the reports. The independent investigation paragraph also included mutual releases “from any claims that might arise as a result of any determination that the value of [Chief] . . . was more or less than” the agreed redemption price at the time of the closing.

In a separate paragraph entitled “mutual releases” each party released the other from all claims that “they had or have arising from, based upon, relating to, or in connection with the formation, operation, management, dissolution and liquidation of [Chief] or the redemption of” Allen’s interest in Chief, except for claims for breach of the redemption agreement or breach of the note associated with the redemption agreement. Another paragraph contained a “merger clause” stating that the redemption agreement “supersedes all prior agreements and undertakings, whether oral or written, between the parties with respect to the subject matter hereof.”

Allen argued that fraudulent inducement invalidates the release provisions in the redemption agreement as “fraud vitiates whatever it touches,”<sup>13</sup> citing *Stonecipher v. Butts*.<sup>14</sup> In rejecting that argument but holding that the release provisions in the redemption agreement were not sufficiently explicit to negate Allen’s fraud in the inducement claims, the Court of Appeals wrote:

The threshold requirement for an effective disclaimer of reliance is that the contract language be “clear and unequivocal” in its expression of the parties’ intent to disclaim reliance. In imposing this requirement, the Texas Supreme Court has balanced three competing concerns. First, a victim of fraud should not be able to surrender its fraud claims unintentionally. Second, the law favors granting parties the freedom to contract knowing that courts will enforce their contracts’ terms, as

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<sup>13</sup> *Id.* at 368.

<sup>14</sup> 591 S.W.2d 806, 809 (Tex. 1979).

well as the ability to contractually resolve disputes between themselves fully and finally. Third, a party should not be permitted to claim fraud when he represented in the parties' contract that he did not rely on a representation . . . [internal citations omitted]<sup>15</sup>

The Court then said that in view of these competing concerns, Texas allows a disclaimer of reliance to preclude a fraudulent inducement claim only if the parties' intent to release such claims "is clear and specific."<sup>16</sup> Among the failings the Court found with the disclaimer language in the redemption agreement were: (i) it did not say none of the parties is relying upon any statement or any representation of any agent of the parties being released hereby; (ii) the broad language releasing "all claims, demands, rights, liabilities, and causes of action of any kind or nature" did not specifically release fraudulent inducement claims or disclaim reliance on Rees-Jones and Chief's representations (although it did release claims "of any kind or nature" (which necessarily includes fraudulent inducement), the elevated requirement of precise language requires more than a general catch-all—it must address fraud claims in clear and explicit language); (iii) the merger clause stated that the contract is the "final integration of the undertakings of the parties hereto and supersedes all prior agreements and undertakings," but did not include clear and unequivocal disclaimer of reliance on oral representations; (iv) the redemption agreement failed to state that the only representations that had been made were those set forth in the agreement; (v) it did not contain a broad disclaimer that no extra-contractual representations had been made and that no duty existed to make any disclosures; (vi) it did not provide that Allen had not relied on any representations or omissions by Chief; or (vii) it did not include a specific "no liability" clause stating that the party providing certain information will not be liable for any other person's use of the information.

The Court was careful to state it was not requiring that the words "disclaimer of reliance" must be stated in order for a disclaimer to preclude a fraudulent inducement claim or that each one of these issues must be addressed in every disclaimer.<sup>17</sup> Rather, the Court stated that the redemption agreement lacked the following: "(1) an all-embracing disclaimer that Allen had not relied on any representations or omissions by Chief; (2) a specific 'no liability' clause stating that the party providing certain information will not be liable for any other person's use of the information; and (3) a specific waiver of any claim for fraudulent inducement based on misrepresentations or omissions."<sup>18</sup>

Although the independent investigation clause stated that Allen "based his decision to sell" on (1) his own independent due diligence investigation, (2) his own expertise and judgment, and (3) the advice and counsel of his own advisors and consultants, the Court found that the statement of reliance on the identified factors did not clearly and unequivocally negate the possibility that Allen also relied on information he had obtained from Chief and Rees-Jones, and consistent with the terms of the redemption agreement, Allen could have relied on both.<sup>19</sup> The Court found it incongruous to state that Allen could not rely on the information he

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<sup>15</sup> *Allen*, 367 S.W.3d at 377-78.

<sup>16</sup> *Id.* at 378.

<sup>17</sup> *Id.* at 380.

<sup>18</sup> *Id.* (citing *Extra Equipamentos E Exportacao Ltda v. Case Corp.*, 541 F.3d 719, 724 (7th Cir. 2008)).

<sup>19</sup> *Id.* at 380.

was given, and noted the absence of the words “only,” “exclusively,” or “solely” are of critical importance in this case.<sup>20</sup>

Rees-Jones and Devon argued that the redemption agreement contained language that released Allen’s claims against them and that this language shows that the parties agreed broadly to disavow the factual theories he now asserts in his lawsuit.<sup>21</sup> Although the redemption agreement released the parties from claims that arise from a determination that the redemption price did not reflect Chief’s market value at closing, it did not negate Allen’s claims that Rees-Jones made misrepresentations and omissions concerning Chief’s future prospects.<sup>22</sup> Further the release disclaimed any claim by Allen based on a change in value from the 2003 appraisal to the date of redemption only, but the language did not cover Allen’s claims that Rees-Jones and Chief withheld information relating to Chief’s future prospects and potential value.<sup>23</sup>

The Court further wrote, citing *Forest Oil Corp. v. McAllen*,<sup>24</sup> that even a clear and unequivocal disclaimer of reliance may not bar a fraudulent inducement claim unless (1) the terms of the contract were negotiated and not boilerplate; (2) the complaining party was represented by counsel; (3) the parties dealt with each other at arm’s length; and (4) the parties were knowledgeable in business matters.<sup>25</sup> The Court found for defendants on two of the factors (Allen as an oil and gas attorney could not complain that he was not represented by counsel and was not knowledgeable).<sup>26</sup> The Court, however, found fact issues as to the other two factors (whether the contract was negotiated and whether the parties dealt with each other at arm’s length) and declined to grant Defendant’s motion for summary judgment.<sup>27</sup> The Court declined to say whether all four tests must be satisfied for an otherwise clear and unequivocal disclaimer of reliance to be enforceable.

In *Staton Holdings, Inc. v. Tatum, L.L.C.*,<sup>28</sup> a Texas Court of Appeals held, as a matter of first impression, that an express-intent requirement, under which a release of liability is enforceable only if the intent to grant such a release is expressed in specific terms within the four corners of the contract, applies to prospective releases of future breaches of warranty in service transactions. In so holding, the Court wrote:

We begin by reviewing Texas’s express-negligence jurisprudence. Under Texas law, certain kinds of contractual provisions that call for an extraordinary shifting of risk between the parties are subject to the fair-notice doctrine. *See Dresser Indus., Inc. v. Page Petroleum, Inc.*, 853 S.W.2d 505, 508 (Tex. 1993). In *Dresser Industries*, the Texas Supreme Court held that a release of liability for future

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<sup>20</sup> *Id.* at 379-80.

<sup>21</sup> *Id.* at 381-82.

<sup>22</sup> *Id.*

<sup>23</sup> *Id.*

<sup>24</sup> 268 S.W.3d 51 (Tex. 2008).

<sup>25</sup> *Allen*, 367 S.W.3d at 383.

<sup>26</sup> *Id.*

<sup>27</sup> *Id.* at 383-84.

<sup>28</sup> 345 S.W.3d 729 (Tex. App.—Dallas 2011, pet. denied).

negligence is enforceable only if it comports with both prongs of the fair-notice doctrine: the conspicuousness requirement and the express-negligence test. *Id.* at 509. Under the express-negligence test, a release of future negligence is enforceable only if the intent to grant such a release is expressed in specific terms within the four corners of the contract. *Id.* at 508; *see also Ethyl Corp. v. Daniel Constr. Co.*, 725 S.W.2d 705, 708 (Tex. 1987) (adopting the express-negligence test in the context of indemnity clauses). If a similar express-intent rule applies to breach-of-warranty claims, the release involved in this case is suspect because it does not expressly state that Staton is waiving claims for future breaches of warranty.

The Texas Supreme Court has extended the express-negligence test to some claims besides negligence. In 1994, the supreme court held that an indemnity agreement will not be construed to indemnify a party against statutorily imposed strict liability unless the agreement expressly states the parties' intent to provide for indemnification of such claims. *Houston Lighting & Power Co. v. Atchison, Topeka & Santa Fe Ry. Co.*, 890 S.W.2d 455, 458-59 (Tex. 1994). The court indicated that the same express-intent rule would apply to claims for strict products liability.

\* \* \*

After considering the reasons supporting *HL & P*'s extension of the express-intent rule to strict liability, we conclude the express-intent rule applies to breach-of-warranty claims.

\* \* \*

The release involved in this case does not expressly release claims for future breaches of warranty, so it does not bar Staton's breach-of-warranty claims . . .<sup>29</sup>

The *Staton Holdings* case is another example of a Texas court acknowledging that Texas law respects the freedom of contract, including the right of parties to contractually limit their tort and other liabilities arising in respect of contracts, but that the Texas courts regard such a shifting of liability as so extraordinary that they require it to be clear, unequivocal and conspicuous in the contract so that there is no question that the parties knowingly bargained for that outcome. In that respect *Staton Holdings* is consistent with the results in *Italian Cowboy* and *Allen*, although the application of express negligence principles was new and an extension. These three 2011 cases suggest that the following principles should be considered when attempting to contractually limit liabilities under Texas law:

- Do not appear to use boilerplate provisions, however comprehensive, and tailor the limitation of liability provision for each transaction in a way that shows that it has been specifically negotiated and is not merely a boilerplate provision.
- Expressly disclaim reliance on any representations that are not embodied in the four corners of the agreement, and perhaps even in particular enumerated

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<sup>29</sup> *Id.* 373-75.

sections thereof.

- Expressly state that no reliance is being placed on any statements (i) by any representative of any of the parties whose liability is limited or (ii) in the data room (if such is the case).
- Expressly state that fraud in the inducement claims are being released.
- Expressly state that no reliance has been placed on any prior representations.
- Include both broad inclusive words of limitation of liability and then specifically address the particular kinds of representations not being relied upon.
- Put the limitation of liability provision in italics, bold face or other conspicuous type.<sup>30</sup>

A non-reliance provision based on those Texas principles might read as follows:

— **Entire Agreement, Non-reliance, Exclusive Remedies and Modification**

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

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

**(c) Following the Closing, the sole and exclusive remedy for any and all claims arising under, out of, or related to this Agreement, or the sale and purchase of the Seller,**

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<sup>30</sup> See Byron F. Egan, *Indemnification in M&A Transactions for Strict Liability or Indemnitee Negligence: The Express Negligence Doctrine*. Univ. of Tex. Sch. of Law 10<sup>th</sup> Annual Mergers and Acquisitions Institute (Oct. 17, 2014). available at <http://images.jw.com/com/publications/2020.pdf>.

shall be the rights of indemnification set forth in Article 11 [the indemnification section of the Agreement] only, and no person will have any other entitlement, remedy or recourse, whether in contract, tort or otherwise, it being agreed that all of such other remedies, entitlements and recourse are expressly waived and released by the parties hereto to the fullest extent permitted by law.

(d) The provisions of this Section 13.7 [the entire agreement provision] and the limited remedies provided in Article 11, were specifically bargained for between Buyer and Sellers and were taken into account by Buyer and the Sellers in arriving at the Purchase Price. The Sellers have specifically relied upon the provisions of this Section 13.7 and the limited remedies provided in Article 11 in agreeing to the Purchase Price and in agreeing to provide the specific representations and warranties set forth herein.<sup>31</sup>

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

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

While the foregoing provision is lengthy and is intended to address the concerns expressed by the courts in the *Italian Cowboy*, *Allen* and *Staton Holdings* cases, circumstances and future cases will no doubt suggest revision of the foregoing in particular cases.

### III. DE FACTO STANDSTILL

In *Martin Marietta Materials, Inc. v. Vulcan Materials Co.*,<sup>32</sup> the Delaware Supreme

<sup>31</sup> This alternative is derived from the Model Provisions suggested in Glenn D. West and W. Benton Lewis, Jr., *Contracting to Avoid Extra-Contractual Liability—Can Your Contractual Deal Ever Really Be the “Entire” Deal?*, 64 BUS. LAW. 999, 1038 (Aug. 2009), as well as the *Italian Cowboy*, *Allen* and *Staton Holdings* cases discussed above; see Byron F. Egan, Patricia O. Vella and Glenn D. West, *Contractual Limitations on Seller Liability in M&A Agreements*, Univ. of Tex. Sch. of Law 8th Annual Mergers and Acquisitions Inst., (Oct. 18, 2012) at Appendix B, available at <http://images.jw.com/com/publications/1790.pdf>.

<sup>32</sup> 68 A.3d 1208 (Del. July 10, 2012), affirming *Martin Marietta Materials, Inc. v. Vulcan Materials Co.*, 56

Court upheld a pair of NDAs and temporarily enjoined Martin Marietta Materials from prosecuting a proxy contest and proceeding with a hostile bid for its industry rival Vulcan Materials Company. After years of communications regarding interest in a friendly transaction, Vulcan and Martin Marietta in the spring of 2010 executed two NDAs to enable their merger and antitrust discussions, each governed by Delaware law:

- A general non-disclosure agreement requiring each party to use the other's confidential information "solely for the purpose of evaluating a Transaction," which was defined as "a possible business combination transaction . . . between" the two companies, and prohibiting disclosure of the other party's evaluation material and of the parties' negotiations except as provided in the agreement, which had a term of two years.
- A joint defense and confidentiality agreement, intended to facilitate antitrust review signed about two weeks after the non-disclosure agreement requiring each party to use the other's confidential information "solely for the purposes of pursuing and completing the Transaction," which was defined as "a potential transaction being discussed by" the parties, and restricting disclosure of confidential materials.

Neither NDA contained an express standstill provision. When the agreements were signed, both parties were seeking to avoid being the target of an unsolicited offer by the other or by another buyer. Accordingly, the agreements protected from disclosure the companies' confidential information as well as the fact that the parties had merger discussions.

After its economic position improved relative to Vulcan, Martin Marietta decided to make a hostile bid for Vulcan and also launched a proxy contest designed to make Vulcan more receptive to its offer. The Court found that Martin Marietta used protected confidential material in making and launching its hostile bid and proxy contest.

The Court then construed the language of the NDAs to determine that Martin Marietta had breached those agreements by (1) using protected information in formulating a hostile bid, since the information was only to be used in an agreed-to business combination; (2) selectively disclosing protected information in one-sided securities filings related to its hostile bid, when such information was not disclosed in response to a third-party demand and when Martin Marietta failed to comply with the agreements' notice and consent process; and (3) disclosing protected information in non-SEC communications in an effort to "sell" its hostile bid. The Court emphasized that its decision was based entirely on contract law, and its reasoning did not rely on any fiduciary principles.

The Court held that, although the NDAs did not expressly include a standstill provision, Martin Marietta's breaches entitled Vulcan to specific performance of the agreements and an injunction. The Court therefore enjoined Martin Marietta, for four months, from prosecuting a proxy contest, making an exchange or tender offer, or otherwise taking steps to acquire control

of Vulcan's shares or assets.

#### **IV. EXPRESS STANDBLILL AND “DON’T ASK, DON’T WAIVE” PROVISIONS**

Some NDAs do contain express standstill provisions that (i) prohibit the bidder from making an offer for the target without an express invitation from its Board and (ii) preclude the bidder from publicly or privately asking the Board to waive the restriction.<sup>33</sup> Such provisions in NDAs, which are sometimes referred to as “Don’t Ask, Don’t Waive” provisions, are designed to extract the highest possible offer from the bidder because the bidder only has one opportunity to make an offer for the target unless the target invites the bidder to make another offer *sua sponte*.<sup>34</sup> Bidders who do not execute NDAs with “Don’t Ask, Don’t Waive” provisions generally are not precluded from submitting multiple offers for the company, even after a winning bidder emerges from an auction.<sup>35</sup>

The legitimacy of “Don’t Ask, Don’t Waive” provisions was recognized in *In re Topps Co. Shareholders Litigation*,<sup>36</sup> in which Delaware Vice Chancellor (now Supreme Court Chief Justice) Strine enjoined a stockholder vote on a merger until the target waived a standstill agreement. The target’s Board had refused to waive the standstill in order to permit a strategic rival to make a tender offer on the same terms it had proposed to the Board and to communicate with Topps stockholders in connection with the vote on the proposed transaction the Board had approved with a private equity investor. In holding that the Board was misusing the standstill agreement solely in order to deny its stockholders the opportunity to accept an arguably more attractive deal and to preclude them from receiving additional information about rival’s version of events, the Court wrote that standstill agreements can have legitimate purposes, including in the final round of an auction where a Board in good faith seeks to extract the last dollar from the remaining bidders, but can be subject to abuse:

Standstills serve legitimate purposes. When a corporation is running a sale process, it is responsible, if not mandated, for the board to ensure that confidential information is not misused by bidders and advisors whose interests are not aligned with the corporation, to establish rules of the game that promote an orderly auction, and to give the corporation leverage to extract concessions from the parties who seek to make a bid.

But standstills are also subject to abuse. Parties like Eisner often, as was done here, insist on a standstill as a deal protection. Furthermore, a standstill can be used

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<sup>33</sup> Peter J. Walsh, Jr., Janine M. Salomone and David B. DiDonato, “*Don’t Ask, Don’t Waive*” Standstill Provisions: Impermissible Limitation on Director Fiduciary Obligations or Legitimate, Value-Maximizing Tool?, ABA Bus. Law Section, Bus. Law Today (Jan. 23, 2013), available at <http://apps.americanbar.org/buslaw/blt/content/2013/01/delawareinsider.shtml>.

<sup>34</sup> *Id.*

<sup>35</sup> *Id.*

<sup>36</sup> 926 A.2d 58 (Del. Ch. 2007); see also Byron F. Egan, *How Recent Fiduciary Duty Cases Affect Advice to Directors and Officers of Delaware and Texas Corporations*, Univ. of Tex. Sch. of Law 35th Annual Conference on Secs. Regulation and Bus. Law (Feb. 14, 2014) at 213-18 nn.669-76, available at <http://images.jw.com/com/publications/1945.pdf>.

by a target improperly to favor one bidder over another, not for reasons consistent with stockholder interest, but because managers prefer one bidder for their own motives.<sup>37</sup>

Later in *In re Celera Corp. Shareholder Litigation*,<sup>38</sup> Vice Chancellor Parsons held that although in isolation the “Don’t Ask, Don’t Waive” provisions arguably fostered the legitimate objectives set forth in *Topps*, when viewed with the no-solicitation provision in the merger agreement, a colorable argument existed that the collective effect created an informational vacuum, increased the risk that directors would lack adequate information, and constituted a breach of fiduciary duty.<sup>39</sup> The Court commented that the “Don’t Ask, Don’t Waive” standstill provisions blocked certain bidders from notifying the Board of their willingness to bid, while the no-solicitation provision in the merger agreement contemporaneously blocked the Board from inquiring further into those parties’ interests, and, thus, diminished the benefits of the Board’s fiduciary-out in the no-solicitation provision and created the possibility that the Board would lack the information necessary to determine whether continued compliance with the merger agreement would violate its fiduciary duty to consider superior offers.<sup>40</sup>

In late 2012, two Chancery Court opinions, *In re Complete Genomics, Inc. Shareholder Litigation*<sup>41</sup> and *In re Ancestry.com Inc. Shareholder Litigation*,<sup>42</sup> considered the propriety of a target company’s inclusion in standstill agreements of a “Don’t Ask, Don’t Waive” provision which became the “emerging issue of December of 2012,” in the words of the Court. In *Complete Genomics* the Board of a company in financial straits decided to explore “all potential strategic alternatives,” including initiation of a process to find a buyer. Prospective bidders were required to sign confidentiality agreements, some of which included standstill provisions that prohibited the bidders from launching a hostile takeover and prohibited the prospective bidders from *publicly* asking the Board to waive the standstill restrictions, but one also forbade the prospective bidder from making a *nonpublic* request for such a waiver.<sup>43</sup> In a bench ruling, Vice Chancellor Laster analogized the “Don’t Ask, Don’t Waive” provision (at least insofar as it prohibited *nonpublic* waiver requests) to “bidder-specific no-talk” clauses criticized by the Court of Chancery in previous cases as being violative of the Board’s “duty to take care to be informed of all material information reasonably available,” rendering it the “legal equivalent of willful blindness” to its fiduciary duties.<sup>44</sup> The Vice Chancellor

<sup>37</sup> 926 A.2d at 91.

<sup>38</sup> No. 6304-VCP, 2012 WL 1020471 (Del. Ch. Mar. 23, 2012) (Transcript), *aff’d in part rev’d in part on other grounds*, 59 A.3d 418 (Del. 2012).

<sup>39</sup> *Id.* at \*15-16.

<sup>40</sup> *Id.*

<sup>41</sup> Telephonic Oral Argument and the Court’s Ruling, *In re Complete Genomics, Inc. S’holder Litig.*, No. 7888-VCL, 2012 WL 9989212 (Del. Ch. Nov. 27, 2012).

<sup>42</sup> Plaintiffs’ Motion for Preliminary Injunction and the Court’s Ruling, *In re Ancestry.com Inc. S’holder Litig.*, No. 7988-CS, 2012 WL 6971058 (Del. Ch. Dec. 17, 2012).

<sup>43</sup> Robert S. Reder, *Delaware Chancellor Weighs in on “Don’t Ask, Don’t Waive” Provision of Standstill Agreement*, Bloomberg BNA Corp. Prac. Library, 28 CCW 24 (2013).

<sup>44</sup> The Vice Chancellor wrote:

In my view, a Don’t Ask, Don’t Waive Standstill resembles a bidder-specific no-talk clause. In *Phelps Dodge Corporation v. Cyrus Amex* [1999 WL 1054255, at \*2 (Del. Ch. Sept. 27, 1999)], Chancellor Chandler considered whether a target board had breached its fiduciary duties

commented that while “a board doesn’t necessarily have an obligation to negotiate,” it “does have an ongoing statutory and fiduciary obligation to provide a current, candid and accurate merger recommendation,” which encompasses “an ongoing fiduciary obligation to review and update its recommendation,” and a “Don’t Ask, Don’t Waive” provision in a standstill is “impermissible” to the extent it limits a Board’s “ongoing statutory and fiduciary obligations to properly evaluate a competing offer, disclose material information, and make a meaningful merger recommendation to its stockholders.” These are ongoing obligations no matter how pristine the process adopted by the Board in making its initial decision to approve a transaction and recommend it to stockholders.

In *Ancestry.com*, the bidders in an auction initiated by the target were required to sign confidentiality agreements containing standstill restrictions that included “Don’t Ask, Don’t Waive” provisions.<sup>45</sup> The ultimate winner in this process was a private equity firm which did not “demand an assignment” of the provision in the merger agreement, thereby leaving it within the target’s discretion whether or not to allow unsuccessful bidders to make unsolicited topping bids prior to receiving stockholder approval. The Court generally praised the process followed by the Ancestry Board, noting that the Board was “trying to create a competitive dynamic” and the process “had a lot of vibrancy and integrity to it . . . .” With respect to the “Don’t Ask, Don’t Waive” provision, the Court noted that while it “is a pretty potent provision,” he was aware of “no statute” or “prior ruling of the Court” that rendered such provisions “per se invalid,” and wrote that a “Don’t Ask, Don’t Waive” provision actually may be used by a “well-motivated seller . . . as a gavel” for “value-maximizing purposes” by communicating to bidders that “there really is an end to the auction for those who participate,” creating an incentive for bidders to “bid your fullest because if you win, you have the confidence of knowing you actually won that auction at least against the other people in the process,” which may attract prospective bidders to a process that has “credibility so that those final-round bidders know the winner is the winner, at least as to them.”

The Court was, however, troubled by the target’s failure to disclose in proxy materials sent to stockholders the potential impact of the “Don’t Ask, Don’t Waive” provision on the bidding process, warned that directors “better be darn careful” in running an auction process to be sure that “if you’re going to use a powerful tool like that, are you using it consistently with your fiduciary duties, not just of loyalty, but of care.” The Court faulted the lack of proxy statement disclosures regarding the “Don’t Ask, Don’t Waive” provision as “probabilistically in violation of the duty of care” since the Board was “not informed about the potency of this clause,” and it “was not used as an auction gavel.” Once the winning bidder “did not demand an assignment of it,” the Board did not “waive it in order to facilitate those bidders which had signed up the standstills being able to make a superior proposal.” The Court “enjoin[ed] the deal subject to those disclosures being promptly made.”

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by entering into a merger agreement containing a no-talk provision. Unlike a traditional no-shop clause, which permits a target board to communicate with acquirers under limited circumstances, a no-talk clause – and here I’m quoting from the Chancellor – “not only prevents a party from soliciting superior offers or providing information to third parties, but also from talking to or holding discussions with third parties.”

<sup>45</sup> Robert S. Reder, *Delaware Chancellor Weighs in on “Don’t Ask, Don’t Waive” Provision of Standstill Agreement*, Bloomberg BNA Corp. Prac. Library, 28 CCW 24 (2013).

**V. LESSONS FROM THE CASES**

The cases discussed above teach that even a simple agreement to maintain the confidentiality of information can be enforced in ways that can change the course of a major transaction. Further, the emphasis placed by the Courts on the directors understanding the power of NDA provisions suggests that counsel should consider the implications thereof on the fiduciary duties of directors and help their clients understand them.

## ***HALLIBURTON II: SUPREME COURT CLARIFIES LONGSTANDING SECURITIES FRAUD CLASS CERTIFICATION ISSUE***

Roger B. Greenberg and Zach Wolfe\*

In its eagerly anticipated opinion in *Halliburton Co. v. Erica P. John Fund, Inc.* (“*Halliburton II*”), the U.S. Supreme Court rejected Halliburton’s invitation to severely limit securities fraud class actions by overruling the “fraud on the market” presumption of reliance established by *Basic Inc. v. Levinson*<sup>1</sup>, but the Court agreed with Halliburton that defendants should be allowed to defeat class certification by showing a lack of “price impact” at the class certification stage of the litigation.<sup>2</sup> So what would be the appropriate headline for a story announcing the decision in *Halliburton II*? “Supreme Court Keeps Securities Fraud Class Actions Alive” or “Supreme Court Gives Corporations A New Way to Defeat Securities Fraud Class Actions”? Both descriptions are accurate, so the difference depends on one’s perspective and expectations. Securities fraud litigators, fearing the possible elimination of their practice area, must have breathed collective sighs of relief. Conversely, for public companies hoping the Court would end securities fraud class actions, the outcome of *Halliburton II* was a disappointment, but the case does give corporations facing such lawsuits a clear weapon in their arsenals.

### **I. THE *BASIC* PRESUMPTION OF RELIANCE IN SECURITIES FRAUD CLASS ACTIONS**

So what is the *Basic* presumption and why is the presumption essential to securities fraud class actions? The answer has to do with the “reliance” element of a typical federal securities fraud claim and the “predominance” requirement of Rule 23 of the Federal Rules of Civil Procedure. The Supreme Court has long recognized an implied private cause of action under Section 10(b) of the Securities Exchange Act of 1934, as implemented by the SEC’s Rule 10b-5 (a “10b-5 claim”).<sup>3</sup> One of the elements of a 10b-5 claim is that the plaintiff relied on the defendant’s misrepresentation or omission in deciding to buy or sell securities. This can be simple enough for individual plaintiffs to prove, but the reliance element becomes problematic in a class action. Rule 23(b)(3) allows class actions where “common questions” of law or fact “predominate” over individual questions. If every member of a proposed class had to prove direct reliance on a misrepresentation, this “predominance” requirement would not be met, and

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<sup>1</sup> 485 U.S. 224 (1988).

<sup>2</sup> *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S.Ct. 2398, 2417 (2014); *Basic Inc. v. Levinson*, 485 U.S. 224 (1988).

<sup>3</sup> 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5; *see Halliburton II*, 134 S.Ct. at 2407.

the case could not proceed as a class action.<sup>4</sup> Thus, the reliance element of a 10b-5 claim would make a 10b-5 class action virtually impossible.

Enter the *Basic* presumption of reliance. *Basic* held that securities fraud plaintiffs could invoke a rebuttable presumption of reliance, rather than proving “direct” reliance on a misrepresentation. The presumption was based on the “fraud-on-the-market” theory, which says that “the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations.” In a sense, it is a two-part presumption: first, the market as a whole is presumed to have “relied” on the misrepresentation, and second, the individual investor is presumed to rely on the integrity of the market. To invoke the presumption, a plaintiff must show that (1) the misrepresentation was public, (2) the misrepresentation was material, (3) the stock traded in an “efficient” market, and (4) the plaintiff traded the stock between the time of the misrepresentation and when the truth was revealed.<sup>5</sup> By making this showing, a plaintiff can invoke the presumption as a ground for class certification without offering evidence of direct reliance by individual investors.

However, from the start the *Basic* presumption was supposed to be rebuttable, not conclusive. *Basic* stated that “[a]ny showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price, will be sufficient to rebut the presumption of reliance.” If the defendant rebuts the presumption, the plaintiff then has to prove direct reliance on the defendant’s misrepresentation. But the question *Basic* left unanswered was *when* the defendant could rebut the presumption. Over 25 years later, the Supreme Court has now clarified that issue.

## **II. A SHORT HISTORY OF SECURITIES FRAUD CLASS ACTIONS FROM *BASIC* TO *HALLIBURTON II***

Depending on one’s point of view, the *Basic* presumption either established an essential tool for investors to vindicate their rights and protect the integrity of U.S. securities markets, or it opened the floodgates to a wave of abusive class actions that force U.S. companies to pay extortionate settlements any time there is a significant dip in their stock prices. But one thing is clear. The *Basic* presumption created a whole new area of litigation and made securities fraud class actions a fact of life for large U.S. companies.

So what happened in the years between *Basic* and *Halliburton II* that led to Halliburton urging the Supreme Court to overrule *Basic*? Here is a short chronology that will help to place the *Halliburton II* case in context:

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<sup>4</sup> *Halliburton II*, 134 S.Ct. at 2408.

<sup>5</sup> See *Halliburton II*, 134 S.Ct. at 2408 (discussing *Basic*).

**1988:** The Supreme Court established the fraud-on-the-market presumption for securities fraud class actions in *Basic Inc. v. Levinson*.

**1995:** Congress enacted the Private Securities Litigation Reform Act (“PSLRA”) to curb perceived abuses of private securities fraud litigation. The PSLRA included heightened pleading requirements, a safe harbor for forward-looking statements, a stay of discovery pending resolution of a motion to dismiss, and a requirement of proving that the misrepresentation caused the plaintiff’s loss, i.e. “loss causation.”

**1998:** In response to plaintiffs seeking to get around the PSLRA by filing state law class actions, Congress enacted the Securities Litigation Uniform Standards Act (“SLUSA”), preempting most state court securities fraud class actions.

**2005:** In *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005), the Supreme Court held that, to plead the essential element of loss causation, it is insufficient for the plaintiff merely to allege that the security price was inflated because of the misrepresentation.

**2007:** In *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*, 487 F.3d 261, 269 (5th Cir. 2007), the Fifth Circuit held that a plaintiff must prove loss causation in order to obtain class certification.

**2008:** The district court in the *Halliburton* case applied the Fifth Circuit’s “*Oscar*” rule and denied class certification because the plaintiff failed to establish loss causation.

**2010:** The Fifth Circuit, applying its *Oscar* decision, affirmed the district court’s denial of class certification in *Halliburton*.

**2011:** The Supreme Court granted cert. to resolve a circuit split over the loss causation issue. In the Supreme Court, Halliburton conceded that plaintiffs should not be required to prove “loss causation” to invoke the *Basic* presumption of reliance, but defended the Fifth Circuit’s judgment on the ground that plaintiff failed to prove “price impact.”

**2011:** In *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179 (2011) (“*Halliburton I*”), the Supreme Court reversed the Fifth Circuit. Disapproving of *Oscar*, the Court held that a plaintiff need not show loss causation at the class certification stage in order to invoke the *Basic* presumption of reliance. The Court declined to reach Halliburton’s argument that it should be allowed to defeat class certification by showing lack of “price impact” at the time of the transaction,

instead remanding to the Fifth Circuit to consider that issue. The Fifth Circuit remanded the case to the district court.

**2012:** On remand, the district court granted class certification, implicitly rejecting Halliburton's argument that it could rebut the presumption of reliance by showing absence of price impact. The Fifth Circuit granted Halliburton leave to appeal the district court's class certification order.

**2/27/13:** While Halliburton's appeal was pending in the Fifth Circuit, the Supreme Court decided *Amgen, Inc. v. Connecticut Retirement Plans & Trust Funds*, 133 S.Ct. 1184 (2013), holding that plaintiffs are not required to prove materiality in order to obtain class certification. Four justices in *Amgen* expressed willingness to reconsider the validity of the *Basic* presumption of reliance. *See Amgen*, 133 S.Ct. at 1204 (Alito, J., concurring) ("more recent evidence suggests that the presumption may rest on a faulty economic premise . . . reconsideration of the *Basic* presumption may be appropriate"), and 1208 n.4 (Thomas, J., joined by Scalia and Kennedy, JJ., dissenting) ("The *Basic* decision itself is questionable . . . but the Court has not been asked to revisit *Basic*'s fraud-on-the-market presumption").

**4/30/13:** The Fifth Circuit affirmed the district court's class certification order, finding that allowing the defendant to show lack of price impact at the class certification stage would conflict with the rationale of *Amgen*.

**5/24/13:** Halliburton moved for rehearing *en banc*, reurging its argument about price impact. In addition, in light of the comments made in *Amgen*, Halliburton made the new argument that *Basic* should be overruled and its presumption of reliance discarded.

**6/11/13:** The Fifth Circuit denied Halliburton's motion for rehearing.

**11/15/13:** The Supreme Court granted the writ of certiorari in *Halliburton II*.

**6/23/14:** The Supreme Court issued its opinion in *Halliburton II*.

As the chronology shows, Halliburton seized an opportunity to argue for abandonment of the *Basic* presumption, as opposed to merely arguing for consideration of price impact evidence at the class certification stage. In response to four justices signaling in *Amgen* that they were willing to reconsider *Basic*, Halliburton made the bold argument that *Basic* should be overruled. This raised the stakes significantly. A case that began by raising an interesting—but not groundbreaking—issue concerning price impact turned into a case threatening the viability of securities fraud class actions generally.

Given these stakes, it was not surprising that numerous amici filed briefs in the Supreme Court on both sides of the case. The amici included the SEC, the Department of Justice, state governments, business groups, institutional investors, former members of Congress, economists, law professors, and former SEC officials.<sup>6</sup> In addition to raising the relatively narrow “price impact” issue, *Halliburton II* provided an opportunity for various interest groups to air their views on the wisdom, or lack thereof, of allowing securities fraud class actions at all.

### III. THE MAJORITY OPINION IN *HALLIBURTON II*

Chief Justice Roberts wrote the majority opinion in *Halliburton II*, joined by Justices Kennedy, Ginsburg, Breyer, Sotomayor, and Kagan. The majority opinion declined to overrule *Basic* but ruled in Halliburton’s favor on the price impact issue. Justice Ginsburg filed a short concurring opinion, joined by Justices Breyer and Sotomayor, stating her understanding that the Court’s holding would do little to affect plaintiffs with tenable claims. Justice Thomas wrote a concurring opinion, joined by Justices Scalia and Alito, that reads more like a dissent. Those three justices would have overruled *Basic* entirely. Thus, in a sense, the tally was 6-3 in favor of upholding the *Basic* presumption, and 9-0 in favor of allowing defendants to refute the presumption by showing a lack of price impact at the class certification stage.

#### A. The Court Declines to Overrule *Basic*

Writing for the Court, Chief Justice Roberts first considered Halliburton’s argument for overruling *Basic* and its presumption of reliance. Rather than asking whether *Basic* was correctly decided, the Court asked whether there was any “special justification” for overturning a long-settled precedent and found that Halliburton had failed to make that showing.<sup>7</sup>

After discussing the elements of a 10b-5 claim, the “predominance” requirement of Rule 23, and the rebuttable presumption of reliance established by *Basic*, the Court turned to Halliburton’s two chief arguments that *Basic* erred by allowing securities fraud plaintiffs to invoke a presumption of reliance: (1) the presumption contravenes congressional intent; and (2) the presumption has been undermined by subsequent developments in economic theory. But the Court found that neither argument so discredited *Basic* that it provided the required “special justification” for overruling the decision.<sup>8</sup>

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<sup>6</sup> See Roger B. Greenberg, Thane Tyler Sponsel III & Zachariah Wolfe, *Halliburton’s Second Trip to the Supreme Court: Basic-ally the End of Securities Fraud Class Actions?*, <http://texasbusinesslaw.org/> (last visited Nov. 10, 2014) for a more detailed summary of the arguments made in the amicus briefs.

<sup>7</sup> *Halliburton II*, 134 S.Ct. at 2407.

<sup>8</sup> *Id.* at 2407-08.

### 1. *Congressional Intent*

Halliburton argued that the *Basic* presumption was inconsistent with Congress's intent in passing the 1934 Exchange Act, which did not include an express private cause of action for a violation of Section 10(b), and that the Court should look to Section 18(a), which did create an express private cause of action and did require reliance, as the closest analog in the Act. However, the Court brushed this argument aside because the dissenting justices in *Basic* had made the same argument, the *Basic* majority did not find it persuasive then, and Halliburton provided no new reason to endorse it.<sup>9</sup>

### 2. *Changes in Economic Theory*

The Court gave more attention to Halliburton's second argument for overruling *Basic*, the argument that subsequent developments in economics had discredited the "efficient capital markets hypothesis" underlying *Basic*. Characterizing *Basic* as espousing a "robust view of market efficiency," Halliburton argued that "overwhelming empirical evidence" now "suggests that capital markets are not fundamentally efficient." The Court, however, noted that the academic debate cited by Halliburton was not new. The *Basic* court acknowledged that debate, the Court said, and declined to adopt any particular theory about how quickly market prices change in response to publicly available information. Instead, the Court said, *Basic* relied on the "fairly modest premise" that "market professionals generally consider most publicly announced material statements about companies, thereby affecting stock market prices." Thus, the Court found debates about the *degree* to which stock prices reflect public information to be largely beside the point, especially when even the foremost critics of the efficient capital markets hypothesis—and Halliburton—acknowledged that public information *generally* affects stock prices. Thus, the Court in *Halliburton II* found that Halliburton had not identified the kind of *fundamental* shift in economic theory that would justify overruling an established precedent.<sup>10</sup>

Halliburton also attacked the premise that investors rely on the integrity of the market price, identifying several types of investors who do not assume that the market price accurately reflects a stock's value. But *Basic* never denied the existence of such investors, the Court said in *Halliburton II*. Rather, *Basic* merely found it reasonable to presume that *most* investors will rely on a stock's market price as reflecting all public information. Furthermore, the Court said that even the value investor who attempts to "beat the market" implicitly relies on the fact that a stock's market price will *eventually* reflect material information.<sup>11</sup>

After finding that the economic arguments made by Halliburton had not fundamentally

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<sup>9</sup> *Id.* at 2408-09.

<sup>10</sup> *Id.* at 2409-10.

<sup>11</sup> *Id.* at 2410-11.

undermined the modest economic premises underlying *Basic*, the Court reasoned that the principle of *stare decisis* applies with “special force” to statutory interpretation, because Congress is free to alter the Court’s rulings. Given the possibility that Congress could overturn or modify the reliance requirement in 10b-5 claims, including overturning *Basic*, the Court saw no reason to “exempt” the *Basic* presumption from “ordinary principles” of *stare decisis*.<sup>12</sup>

### 3. *Other Arguments for Overruling Basic*

Halliburton also argued that the *Basic* presumption improperly expanded the judicially created Rule 10b-5 cause of action, that the presumption was inconsistent with the Court’s subsequent decisions, and that the *Basic* presumption produces harmful consequences, but the Court disagreed.

First, the Court explained that the *Basic* presumption does not eliminate the reliance requirement but rather provides an alternative means of satisfying it. Thus, the Court disagreed with Halliburton’s argument that the *Basic* presumption expands the Rule 10b-5 cause of action.<sup>13</sup>

Second, the Court rejected Halliburton’s argument that the presumption of reliance is inconsistent with the Court’s recent class action decisions in *Wal-Mart Stores, Inc. v. Dukes* and *Comcast Corp. v. Behrend*, which require plaintiffs to prove, not merely plead, that a proposed class satisfies the predominance requirement. The Court reasoned that the presumption does not relieve plaintiffs of the burden of proving reliance before class certification but instead establishes a way for plaintiffs to meet that burden.<sup>14</sup>

Third, the Court noted the arguments by Halliburton and several *amici* that securities fraud class actions “allow plaintiffs to extort large settlements from defendants for meritless claims,” “punish innocent shareholders,” “impose excessive costs on businesses,” and “consume a disproportionately large share of judicial resources.” However, the Court found that these concerns should be addressed to Congress, which had already responded to some extent by enacting the PSLRA in 1995 and SLUSA in 1998.<sup>15</sup>

## B. The Court in *Halliburton II* Holds That Defendants Can Defeat Class Certification by Showing Lack of Price Impact

After declining to overrule the *Basic* presumption of reliance, the Court considered Halliburton’s two proposed alternatives: (1) require plaintiffs to prove that a defendant’s

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<sup>12</sup> *Id.* at 2411.

<sup>13</sup> *Id.* at 2411-12

<sup>14</sup> *Id.* at 2412; *Comcast Corp. v. Behrend*, 133 S.Ct. 1426 (2013); *Wal-Mart Stores, Inc. v. Dukes*, 131 S.Ct. 2541 (2011).

<sup>15</sup> *Halliburton II*, 134 S.Ct. at 2413.

misrepresentation actually affected the stock price, i.e. “price impact,” in order to invoke the *Basic* presumption; or (2) allow defendants to rebut the presumption of reliance at the class certification stage with evidence of a lack of price impact. The Court rejected the first alternative but adopted the second.<sup>16</sup>

### **1. *Requiring Plaintiffs to Prove Price Impact***

Halliburton’s first argument was that plaintiffs should be required to prove price impact directly in order to invoke the *Basic* presumption, but the Court said this would “radically” alter the required showing of reliance. The Court explained that the *Basic* presumption actually incorporates two distinct presumptions. First, there is a presumption that the misrepresentation affected the stock price. Second, there is a presumption that the plaintiff purchased the stock in reliance on the defendant’s misrepresentation. By requiring plaintiffs to prove price impact directly, the Court said, Halliburton’s first proposal would take away the first constituent presumption. The Court rejected this proposal. “For the same reasons we declined to completely jettison the *Basic* presumption,” the Court said, “we decline to effectively jettison half of it by revising the prerequisites for invoking it.”<sup>17</sup>

### **2. *Allowing Defendants to Show Lack of Price Impact***

The Court viewed Halliburton’s second alternative proposal more favorably. Halliburton argued that defendants should be allowed to rebut the *Basic* presumption at the class certification stage by offering evidence that the misrepresentation had no price impact. The Court agreed with Halliburton for two reasons.

First, the Court pointed out that defendants can already show a lack of price impact at the merits stage, and that both plaintiffs and defendants already can and do offer such evidence at the class certification stage, but for the purpose of showing market efficiency (or lack thereof). Specifically, plaintiffs offer “event studies” that seek to show that a stock’s price responds to pertinent publicly reported events. The plaintiff in *Halliburton II*, for example, submitted an event study of various episodes expected to affect the price of Halliburton’s stock, including one of the alleged misrepresentations forming the basis for the plaintiff’s suit. What defendants may not do, the plaintiff argued, is rely on that same evidence for the purpose of rebutting the presumption to defeat class certification.<sup>18</sup>

The Court reasoned that this restriction on defendant’s use of price impact evidence makes no sense. Under the plaintiff’s approach, the same evidence offered at the class certification stage on the issue of market efficiency could also show a lack of price impact, yet the district

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<sup>16</sup> *Id.*

<sup>17</sup> *Id.* at 2414.

<sup>18</sup> *Id.* at 2415-16.

court would still certify the class. While it is appropriate to allow plaintiffs to rely on the *Basic* presumption as an “indirect proxy” for price impact, the Court said, “an indirect proxy should not preclude direct evidence when such evidence is available.” The Court found that the *Basic* presumption, which provides plaintiffs an indirect way to prove reliance, should not require courts to ignore a defendant’s “direct, more salient evidence” showing a lack of price impact.<sup>19</sup>

Second, the Court reasoned that allowing defendants to defeat the presumption of reliance by showing a lack of price impact at the class certification stage was consistent with the rationale of the Court’s decision in *Amgen, Inc. v. Connecticut Retirement Plans & Trust Funds*. *Amgen* held that plaintiffs are not required to prove materiality of the misrepresentation at the class certification, reasoning that materiality is an objective element of the 10b-5 claim that is common to the whole class. Plaintiff argued that the same was true of price impact.<sup>20</sup>

The Court disagreed, stating that price impact differs from materiality in the crucial respect that “the common issue of materiality can be left to the merits stage without risking the certification of classes in which individual issues will end up overwhelming common ones.” Price impact, in contrast, is *Basic*’s “fundamental premise.” It therefore “has everything to do with the issue of predominance at the class certification stage.” If there is no price impact, the fraud-on-the-market theory underlying the presumption “completely collapses.” Furthermore, evidence of price impact will be before the court at the class certification stage anyway, and the Court saw no reason to artificially limit the use of price impact evidence at that stage. Thus, the Court held that “Defendants may seek to defeat the *Basic* presumption at that stage through direct as well as indirect price impact evidence.”<sup>21</sup>

#### **IV. JUSTICE GINSBURG’S BRIEF BUT NOTABLE CONCURRING OPINION**

In a very brief concurring opinion joined by Justice Breyer and Justice Sotomayor, Justice Ginsburg wrote:

Advancing price impact consideration from the merits stage to the certification stage may broaden the scope of discovery available at certification. See Tr. of Oral Arg. 36–37. But the Court recognizes that it is incumbent upon the defendant to show the absence of price impact. See *ante*, at 2413 – 2414. The Court’s judgment, therefore, should impose no heavy toll on securities-fraud plaintiffs with tenable claims. On

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<sup>19</sup> *Id.* at 2415.

<sup>20</sup> *Halliburton II*, 134 S.Ct. at 2416-17 (discussing *Amgen, Inc. v. Connecticut Retirement Plans & Trust Funds*, 133 S.Ct. 1184 (2013)).

<sup>21</sup> *Id.* at 2416.

that understanding, I join the Court's opinion.

It seems the concurring justices were trying to accomplish two things. First, the comment about broadening the scope of discovery seemed to say to Halliburton and other defendants, “be careful what you wish for.” Defendants typically seek to keep the scope of discovery as narrow as possible at the class certification stage, but if evidence concerning price impact is to be considered at the class certification stage, the scope of any discovery may include evidence relating to price impact. As discussed in section VI below, the significance of this change remains to be seen. Second, the concurring justices may have hoped to limit the impact of *Halliburton II* by characterizing its holding as not imposing any “heavy toll” on plaintiffs.

## **V. JUSTICE THOMAS'S CONCURRING OPINION ARGUING FOR OVERRULING *BASIC***

In his opinion concurring in the judgment, Justice Thomas, joined by Justices Scalia and Alito, argued that *Basic* was wrongly decided, and that *stare decisis* did not compel the Court to uphold *Basic*. He began by questioning the Rule 10-5 private cause of action itself, calling it a “relic” of days when the Supreme Court assumed common-law powers to create causes of action. Rather than interpreting a statute, Justice Thomas wrote, *Basic* went wrong by setting out to solve the policy “problem” that requiring proof of individualized reliance would bar securities fraud class actions. He criticized the *Basic* court for creating the presumption based on “nascent economic theory” and “naked intuitions” about investment behavior.<sup>22</sup>

### **A. In the View of Justices Thomas, Scalia, and Alito, the *Basic* Presumption Was a Mistake, and Time Has Compounded Its Failings.**

Justice Thomas wrote that the traditional reliance requirement required a plaintiff to show he was aware of a company's statement and engaged in a transaction based on that statement. *Basic* dispensed with that requirement and created a two-part presumption: (1) the market *had* incorporated the specific misrepresentation into the market price of the security, and (2) the plaintiff *did* transact in reliance on the integrity of that price.<sup>23</sup> Justice Thomas argued that this two-part presumption was based on faulty factual assumptions, was inconsistent with the Court's recent Rule 23 cases, and resulted in a “rebuttable” presumption that is virtually irrebuttable in practice.

#### **1. *Faulty Factual Assumptions***

In *Basic*, Justice Thomas said, “the Court based both parts of the presumption of reliance on a questionable understanding of disputed economic theory and flawed intuitions about

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<sup>22</sup> 134 S.Ct. at 2417-18 (Thomas, J. concurring).

<sup>23</sup> *Id.* at 2419.

investor behavior.<sup>24</sup> He argued that the first factual assumption—that public statements are reflected in the market price—“was grounded in an economic theory that has garnered substantial criticism” since *Basic*.<sup>25</sup> In his view, “the second assumption—that investors categorically rely on the integrity of the market price—is simply wrong.”<sup>26</sup>

*Basic* grounded the first assumption in “the nascent economic theory known as the efficient capital markets hypothesis.”<sup>27</sup> Specifically, Justice Thomas wrote, *Basic* endorsed the “semi-strong version of that theory, which posits that the average investor cannot earn above-market returns in an efficient market by trading on the basis of publicly available information, and that the market price of shares traded on well-developed markets will reflect all publicly available information.”<sup>28</sup> At the time of *Basic*, “this theory was widely accepted, Justice Thomas said, but the theory has since lost its luster.”<sup>29</sup> We now know that “even well-developed markets do not uniformly incorporate information into market prices with high speed,”<sup>30</sup> he said, and “overwhelming empirical evidence” suggests that markets often fail to incorporate public information accurately.<sup>31</sup>

Similarly, Justice Thomas rejected the assumption that investors rely on the integrity of the market price:

It cannot be seriously disputed that a great many investors do *not* buy or sell stock based on a belief that the stock’s price accurately reflects its value. Many investors in fact trade for the opposite reason—that is, because they think the market has under- or overvalued the stock, and they believe they can profit from that mispricing.

“Other investors trade for reasons entirely unrelated to price.”<sup>32</sup> In short, Justice Thomas wrote, “*Basic*’s assumption that all investors rely in common on ‘price integrity’ is simply wrong.”<sup>33</sup>

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<sup>24</sup> *Id.* at 2420.

<sup>25</sup> *Id.* (quoting *Basic*, 485 U.S. at 246).

<sup>26</sup> *Id.*

<sup>27</sup> *Id.* at 2420-21 (citing Stout, The Mechanisms of Market Inefficiency: An Introduction to the New Finance, 28 J. CORP. L. 635, 640, and n. 24 (2003)).

<sup>28</sup> *Id.* at 2421 (citing Langevoort, *Basic* at Twenty: Rethinking Fraud on the Market, 2009 WIS. L.REV. 151, 175).

<sup>29</sup> *Id.* (citing Lev and de Villiers, Stock Price Crashes and 10b-5 Damages: A Legal, Economic and Policy Analysis, 47 STAN. L. REV. 7, 20-21 (1994)).

<sup>30</sup> *Id.*

<sup>31</sup> *Id.* (quoting *Basic*, 485 U.S. at 246).

<sup>32</sup> *Id.*

<sup>33</sup> *Id.* at 2422.

## 2. *Inconsistent with Recent Rule 23 Decisions*

Justice Thomas's second ground for overruling *Basic* was that "*Basic*'s rebuttable presumption is at odds with our subsequent Rule 23 cases, which require plaintiffs seeking class certification to 'affirmatively demonstrate' certification requirements like the predominance of common questions."<sup>34</sup> In his view, *Basic* "permits plaintiffs to bypass that requirement of evidentiary proof," because the presumption substitutes for evidence of actual reliance. In effect, Justice Thomas argued, *Basic* "exempts Rule 10b-5 plaintiffs from Rule 23's proof requirement, an exemption that was beyond the *Basic* court's power to grant."<sup>35</sup>

## 3. *Irrebuttable in Practice*

In his third argument for overruling *Basic*, Justice Thomas reasoned that "*Basic*'s presumption that investors rely on the integrity of the market price is virtually irrefutable in practice."<sup>36</sup> In his view, "the realities of class action procedure make rebuttal based on an individual plaintiff's lack of reliance virtually impossible."<sup>37</sup> At the class certification stage, plaintiff's counsel can avoid rebuttal simply by finding just one class representative who can withstand a challenge. "After class certification", Justice Thomas said, "courts typically refuse to allow defendants to challenge any individual plaintiff's reliance on the market price prior to a determination of class-wide liability."<sup>38</sup> In his view, this results in a presumption that is "conclusive in practice," thus effectively eliminating even *Basic*'s "watered-down" reliance requirement.<sup>39</sup>

For all of the reasons discussed above, Justices Thomas, Scalia, and Alito would have overruled *Basic* and required individual plaintiffs to prove "actual reliance, not the fictional 'fraud-on-the-market' version."<sup>40</sup>

## B. *In the View of Justices Thomas, Scalia, and Alito, Stare Decisis Should Not Have Prevented the Court From Overruling Basic.*

In contrast to Justice Roberts' majority opinion, which required a "special justification" for overruling a well established precedent, Justice Thomas said that "[p]rinciples of *stare decisis* do not compel us to save *Basic*'s muddled logic and armchair economics."<sup>41</sup> He

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<sup>34</sup> *Id.* at 2420 (citing *Comcast v. Behrend*, 133 S.Ct. 1426, 1432 (2013)).

<sup>35</sup> *Id.* at 2423-24.

<sup>36</sup> *Id.* at 2420.

<sup>37</sup> *Id.* at 2424 (citing *Grundfest, Damages and Reliance under Section 10(b) of the Exchange Act*, 69 BUS. LAWYER 307, 362 (2014)).

<sup>38</sup> *Id.* (citing Brief for Chamber of Commerce of the United States of America *et al.* as *Amici Curiae* 13–14).

<sup>39</sup> *Id.* at 2424-25.

<sup>40</sup> *Id.* at 2425 (quoting *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 163 (2008)).

<sup>41</sup> Compare 134 S.Ct. at 2407 (Roberts, J., delivering the majority's opinion), with 134 S.Ct. at 2425 (Roberts,

rejected the argument that *stare decisis* had special force in the context of statutory interpretation, where Congress can correct a court's mistakes, by arguing "when we err in areas of judge-made law, we ought to presume that Congress expects us to correct our own mistakes—not the other way around."<sup>42</sup>

Justice Thomas also rejected the notion that Congress had acquiesced in the *Basic* presumption by enacting legislation (such as the PSLRA) concerning private Rule 10b-5 claims without overruling *Basic*.<sup>43</sup> Contrary to the plaintiff's argument, Justice Thomas wrote, "we cannot draw from Congress' silence on this matter an inference that Congress approved of *Basic*."<sup>44</sup> This was especially true with respect to the PSLRA, Justice Thomas pointed out, in which Congress expressly stated that "[n]othing in this Act . . . shall be deemed to create or ratify any implied private right of action."<sup>45</sup> If by passing the PSLRA Congress did not even ratify the implied cause of action, he argued, it certainly did not ratify *Basic*'s expansion of that cause of action.<sup>46</sup>

## VI. QUESTIONS RAISED BY *HALLIBURTON II*

The Supreme Court issued its opinion in *Halliburton II* on June 23, 2014. Because the courts below had denied Halliburton the opportunity to defeat the *Basic* presumption with evidence of a lack of price impact, the Court vacated the Fifth Circuit's judgment and remanded the case.<sup>47</sup> The Fifth Circuit issued a short order remanding the case to the District Court for further proceedings consistent with the Supreme Court's opinion.<sup>48</sup> On August 27, 2014, the District Court issued a scheduling order setting a one-day evidentiary hearing on December 1, 2014 to address price impact.<sup>49</sup> The full impact of the *Halliburton II* decision—both in the Halliburton case itself and in other securities fraud class actions—remains to be seen. But there have been some early indications from the other circuit lower courts concerning some of the issues raised.

### A. How Much Will *Halliburton II* Really Change the Settlement Value of Securities Fraud Class Actions?

For pending and future securities fraud class actions, how much does *Halliburton II*'s

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J., concurring).

<sup>42</sup> *Id.* at 2425-26.

<sup>43</sup> *Id.* at 2426.

<sup>44</sup> *Id.*

<sup>45</sup> *Id.*

<sup>46</sup> *Id.* at 2426-27.

<sup>47</sup> *Id.* at 2417.

<sup>48</sup> Erica P. John Fund, Inc. v. Halliburton Co., 718 F.3d 423 (5th Cir. 2013) *aff'g* 2012 WL 565997 (N.D. Tex. 2012), *rev'd*, 134 S.Ct. 2398 (2014).

<sup>49</sup> Scheduling Order, No. 3:02-cv-1152-M (N.D. Tex. Aug. 27, 2014).

price impact ruling really change things? The effect may be limited to weeding out some weaker cases prior to class certification. For two reasons, one could make a case that the impact of the ruling will be minimal.

First, as one district court addressing *Halliburton II* recently noted, it is important to remember that “proof of price impact has always been a part of the equation at the merits stage of a securities fraud case.”<sup>50</sup> Thus, *Halliburton II* did not create a new element or defense, but only addressed *when* a defendant can raise the price impact issue. As Justice Ginsburg indicated in her concurring opinion, plaintiffs with tenable claims should not have too much difficulty showing price impact.<sup>51</sup> If the plaintiffs have no evidence of price impact, their case was never likely to have more than nuisance value anyway.

Second, some circuits already allowed defendants to refute price impact at the class certification stage.<sup>52</sup> So in these circuits, *Halliburton II* did not change the law.

Thus, *Halliburton II* will likely have the most impact in circuits where the defendants previously could not refute price impact, and in cases where the plaintiff’s evidence on the merits was already weak. In cases that are strong enough to survive a motion to dismiss, but the evidence of price impact is weak, *Halliburton II* gives defendants additional settlement leverage prior to class certification. Plaintiffs in those cases may be more inclined to settle earlier, and for less money. That may be the most likely practical effect of the price impact ruling.

## B. What Evidence Is Necessary to Prove a Lack of “Price Impact”?

The issue in *Halliburton II* was *when* defendants can address price impact, so the Court did not focus on *what* defendants must do to show a lack of price impact. Is it sufficient to offer evidence that the price of the company’s stock did not move in response to the alleged misrepresentations at the time when the misrepresentations were made? What is the threshold showing? In an effort to defeat class certification, Defendants will typically try to offer evidence that the stock price did not move in response to the alleged misrepresentation, but that may not be enough.

In “price maintenance” cases, the plaintiff will argue that the defendant’s misrepresentation or omission was “confirmatory information” that helped to maintain the

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<sup>50</sup> *In re Vivendi Universal, S.A. Sec. Litig.*, No. 02-CV-5571 (SAS), 2014 WL 4080950, at \*1 (S.D.N.Y. Aug. 18, 2014).

<sup>51</sup> 134 S.Ct. at 2417 (Ginsburg, J., concurring).

<sup>52</sup> See *McIntire v. China MediaExpress Holdings, Inc.*, No. 11-cv-0804 (VM), 2014 WL 4049896, at \*13 (S.D.N.Y. Aug. 15, 2014) (holding that “*Halliburton II* did not change Second Circuit case law, which already permitted a securities-fraud defendant ‘to rebut the presumption, prior to class certification, by showing, for example, the absence of a price impact’”).

price of the company's stock, rather than causing a price increase. Typically, the plaintiff will offer evidence that the stock price declined when the truth became public, i.e. when there was a "corrective disclosure." Is the evidence of price decline following a corrective disclosure sufficient for a plaintiff to show price impact at the class certification stage? The Supreme Court did not address these questions in *Halliburton II*, so it will be up to the lower courts to determine whether the defendant has carried its burden to prove a lack of price impact at the class certification stage.

The Eleventh Circuit touched on the interaction between the *Halliburton II* ruling and the price maintenance theory in *Local 703 v. Regions*.<sup>53</sup> In that case, the District Court ruled—prior to issuance of the *Halliburton II* opinion—that the plaintiffs had met the prerequisites for invoking the *Basic* presumption of reliance, including showing an efficient market, and certified a class of purchasers of Regions stock.<sup>54</sup> On appeal, Regions argued that the evidence was insufficient to support the District Court's finding that the stock traded on an efficient market.<sup>55</sup> The Court of Appeals rejected this argument, but in the meantime the Supreme Court had decided *Halliburton II*, and both sides agreed that the case should be remanded to the District Court to review the evidence of "price impact" in light of the Supreme Court's decision.<sup>56</sup>

Not surprisingly, the Court of Appeals agreed to the parties' request and remanded the case for that purpose.<sup>57</sup> The more notable thing about the opinion was that the Court of Appeals gave this guidance strongly suggesting the District Court not apply too strict a standard for proof of price impact:

But we are mindful, and the District Court is no doubt aware, that its work on remand will be limited in scope. The Supreme Court only said that defendants "may seek to defeat the *Basic* presumption" with evidence that the misrepresentations did not impact the price. *Halliburton II* by no means holds that in every case in which such evidence is presented, the presumption will always be defeated. Indeed, this Court has recognized the distinct role that confirmatory information may have in this analysis. But in any event, because the District Court is in the best position to review all the facts and conduct the inquiry now required in the wake of *Halliburton II*, we vacate and remand this case for that purpose.<sup>58</sup>

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<sup>53</sup> *Local 703, I.B. of T. Grocery & Food Employees Welfare Fund v. Regions Fin. Corp.*, 762 F.3d 1248 (11th Cir. 2014).

<sup>54</sup> *Id.* at \*1.

<sup>55</sup> *Id.* at \*3.

<sup>56</sup> *Id.* at \*10.

<sup>57</sup> *Id.*

<sup>58</sup> *Local 703*, 762 F.3d at 1259 (internal citation omitted).

The Eleventh Circuit seems to be signaling that evidence of price *maintenance* may be sufficient for the plaintiff to show a price impact and to obtain class certification.

In an opinion issued shortly after *Local 703 v. Regions*, a district court in the Second Circuit directly addressed this issue. In *McIntire v. China MediaExpress Holdings, Inc.*,<sup>59</sup> the plaintiffs asserted Rule 10(b)(5) claims and moved for class certification. The defendant, DTT HK, argued that, even if the company's stock traded on an efficient market, the fraud-on-the-market presumption was rebutted because the company's alleged misrepresentations did not impact the company's stock price.<sup>60</sup> However, the district court reasoned that a showing of price maintenance was sufficient to establish price impact:

DTT HK correctly notes that on the day after it released its 2009 audit opinion—which contains the misstatements that Plaintiffs allege to be actionable—CCME's stock price did not increase, and in fact decreased slightly. DTT HK thus concludes that it has shown the absence of any price impact from its material misstatements. But this simple line of reasoning is flawed. A material misstatement can impact a stock's value either by improperly causing the value to increase *or* by improperly maintaining the existing stock price. *See, e.g., In re Pfizer Inc. Sec. Litig.*, 936 F.Supp.2d 252, 264 (S.D.N.Y. 2013) (“[A] misstatement may cause inflation simply by maintaining existing market expectations, even if it does not actually cause the inflation in the stock price to increase on the day the statement is made.”). Misstatements by an auditor confirming the accuracy of a company's (inaccurate) financial statements may be particularly likely to maintain an already-inflated stock price because the market likely expects an auditor to issue such an opinion.<sup>61</sup>

Thus, the defendant could not refute price impact—and defeat class certification—merely by showing that the stock price did not go up immediately after the alleged misrepresentation was made. Looking at the evidence, the district court was “not persuaded that DTT HK has met its burden to prove that its alleged misstatements did not improperly maintain CCME's already-inflated stock price.”<sup>62</sup> The court granted class certification.<sup>63</sup> Thus, at least one post-*Halliburton II* case has held that the plaintiff can show price impact and obtain class certification through a price maintenance theory.

Whether evidence of “price maintenance” is sufficient to show “price impact” is just one of the issues that may arise when a defendant tries to show a lack of price impact under

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<sup>59</sup> No. 11-cv-0804, 2014 WL 4049896, \*1 (S.D.N.Y. Aug. 15, 2014).

<sup>60</sup> *Id.* at \*13.

<sup>61</sup> *Id.*

<sup>62</sup> *Id.* at \*40.

<sup>63</sup> *Id.* at \*15.

*Halliburton II*. Although the Supreme Court made it clear that the burden of showing a lack of price impact is on the defendant at the class certification stage, it did not specifically address how the district court should address conflicting evidence. If the defendant offers some evidence demonstrating a lack of price impact in opposition to class certification, then the burden shifts to the plaintiff, but what is the plaintiff's burden? Is it sufficient for the plaintiff merely to offer some evidence of price impact—and raise a fact issue—or does the district court then act as fact-finder and resolve the conflicting evidence? More pointedly, if there is conflicting expert testimony on price impact at the class certification stage, does the plaintiff automatically win, or is the court's job to decide the battle of experts? It remains to be seen how this will play out after *Halliburton II*.

### C. How Will *Halliburton II* Affect the Scope of Discovery Prior to Class Certification?

As Justice Ginsburg noted, advancing consideration of price impact evidence to the class certification stage may broaden the scope of class certification discovery.<sup>64</sup> Under *Halliburton II*, parties should be permitted to seek discovery relevant to price impact prior to class certification. But how much does this really broaden discovery? Market efficiency was already an issue at the class certification stage. As the *Halliburton II* majority noted, price impact evidence was already part of the evidence at class certification because one of the ways to show an efficient market is to show that a company's public statements tend to affect its stock price, i.e. price impact.<sup>65</sup> So in practical terms the scope of discovery may not change significantly. Of course, discovery rulings will depend on the specific facts and circumstances of each case.

Taking depositions of corporate executives concerning price impact is likely to be a recurring issue in proposed securities fraud class actions. Plaintiffs may try to use *Halliburton II* as a basis for taking early depositions of company officers prior to class certification, arguing that the officers may have knowledge relevant to price impact. Defendants will tend to try to avoid such depositions, arguing that internal corporate knowledge has little or no bearing on price impact.

The Halliburton case itself provides a good example. After remand to the district court, the plaintiff sought the depositions of Halliburton CEO, David Lesar, and former CFO, Douglas Foshee, arguing their depositions should be allowed even during a stay of merits discovery because they have personal knowledge relevant to price impact. Halliburton argued that these executives are not experts in econometrics or price impact, and that their views on why or how any Halliburton statement impacted the stock price are not relevant. “Non-public information—including Halliburton’s internal knowledge and beliefs—is irrelevant to the

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<sup>64</sup> *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398, 2417 (2014) (Ginsberg, R., concurring).

<sup>65</sup> 134 S.Ct. at 2415.

fraud-on-the-market presumption and price impact," Halliburton said. The district court declined to allow the depositions, but left the door open for plaintiff to come back with any new grounds showing that a specific deposition would be relevant to price impact.<sup>66</sup>

This may be a preview of similar arguments to come in other securities fraud class actions. Plaintiffs will likely try to use *Halliburton II* to expand the scope of discovery regarding price impact before class certification, while defendants will typically argue that depositions of corporate executives have nothing to do with price impact. Even aside from depositions, there are likely to be similar arguments over the scope of document discovery. Earlier discovery disputes about what is relevant to price impact—and what is not—may be an unintended consequence of *Halliburton II*'s price impact ruling.

#### **D. What Will the Role of Experts Be After *Halliburton II*?**

To show price impact or a lack thereof, parties will often hire expert economists, who will perform "event studies" to analyze the effect of a particular event, e.g. a misrepresentation or a corrective disclosure, on a company's stock price. After *Halliburton II*, will it become routine for parties to hire experts at the class certification stage to analyze and testify regarding price impact? That seems likely, but it may not be a drastic change. Experts can already testify at the class certification stage on the issue of market efficiency, which indirectly addresses price impact. The difference after *Halliburton II* is that now experts will address price impact directly. In the remanded Halliburton case, for example, the district court issued a scheduling order setting deadlines for expert reports for both sides on the issue of price impact.<sup>67</sup> This seems likely to become the norm.

### **VII. CONCLUSION**

The biggest news about the *Halliburton II* opinion is not what the Supreme Court did, but what it did not do. The Court did not overrule *Basic* and abolish the fraud-on-the-market presumption. Thus, the Court kept private securities fraud class actions intact. However, the Court did make it a little easier for defendants to eliminate them earlier in the litigation. Thus, the decision in *Halliburton II* to allow defendants to defeat class certification by showing lack of price impact can be viewed as the latest in a series of steps that both Congress and the Supreme Court have taken to tilt the balance in securities fraud class actions towards defendants. Like the PSLRA and SLUSA, which gave defendants new substantive and procedural advantages, *Halliburton II* gives defense counsel an additional peremptory tool for seeking dismissal of securities fraud class actions. It remains to be seen how powerful a tool this will be, and whether plaintiffs will turn *Halliburton II* to their advantage by seeking

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<sup>66</sup> See Document 576, Halliburton's Motion for Protective Order, Case No. 3:02-cv-1152-M.

<sup>67</sup> See Document 568, Scheduling Order: A Full Day Hearing, to Consider the Issue of Price Impact as it Relates to the Fraud on the Market Presumption, as Germane to Class Certification, Case No. 3:02-cv-1152-M.

broader discovery in the early stages of securities fraud class actions.



# INTELLECTUAL PROPERTY 101

Irene Kosturakis\*

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## I. THE CONCEPT OF INTELLECTUAL PROPERTY

Intellectual property (IP) is a legal concept which refers to creations of the mind for which exclusive rights are legally recognized. Under intellectual property law, owners are granted certain exclusive rights to a variety of intangible assets, such as musical, literary, and artistic works; discoveries and inventions; words, phrases, symbols, and designs; and information and ideas. Common types of intellectual property rights include copyright, patents, trademarks, industrial design rights, trade dress, and in some jurisdictions, trade secrets.

### A. Intellectual Property and Intellectual Property Rights – Historical Development

The protection of intellectual property goes back at least to the middle ages in Venice, Europe. Medieval technology in the various trades and arts was developed by guilds, which required the apprenticeship of years before an indentured apprentice would finally be admitted as a full member into the trade or guild and become the beneficiary of closely-held knowledge about the trade.<sup>1</sup> Motivated by political and religious interests, this knowledge (or intellectual property of the times) was controlled by such guilds. They became powerful through government-granted monopolistic rights that allowed them to control and regulate their trade, such as what could be imported, marketed, and produced and even the manner in which new technology, know-how, and procedures could be used within the trade.<sup>2</sup> The concentration of this knowledge and skill in a select few resulted in a system that stifled rather than fostered innovation and severely limited its benefit to society.

Two antique laws form the basis of current intellectual property law as we know it. The first is the British “Statute of Monopolies” (1623), which provided a limited monopoly of fourteen years of exclusivity to a “true and first inventor” of a patent.<sup>3</sup> The second is the British Statute of Anne (1710), considered the first copyright statute, which established copyright rights in authors of writings for a period of fourteen years.<sup>4</sup>

Intellectual property law in the United States developed initially in the thirteen colonies, each of which passed individual IP laws, leading to conflicting and unenforceability problems

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<sup>1</sup> *History and Sources of Intellectual Property Law*, NAT'L PARALEGAL COLL., [http://nationalparalegal.edu/public\\_documents/courseware.asp\\_files/patents/IntroIP/History.asp](http://nationalparalegal.edu/public_documents/courseware.asp_files/patents/IntroIP/History.asp) (last visited Jan. 28, 2014); Frank D. Prager, *History of Intellectual Property From 1545 to 1787*, 26(11) J. PATENT OFFICE SOC'Y 713 (1944).

<sup>2</sup> See *id.*

<sup>3</sup> *Statute of Monopolies 1623*, LEGISLATION.GOV.UK, <http://www.legislation.gov.uk/aep/Ja1/21/3/section/VI> (last visited Jan. 28, 2014).

<sup>4</sup> Karl-Erik Tallmo, *The History of Copyright: A Critical Overview with Source Texts in Five Languages*, <http://www.copyrighthistory.com/anne.html> (last visited Jan. 28, 2014) (a forthcoming book) (referencing and incorporating within what is known as the first copyright statute, The Statute of Anne, 1710 (1/6)).

outside each colony.<sup>5</sup> To remedy this, a system of centralized and federalized laws was therefore established in the U.S. Constitution by the founding fathers who in their wisdom recognized that taking care of this situation was important to the young country's progress. Fundamental to this had to have been the recognition that invention yields improvement, which begets more invention and results in progress for society, but only if that invention, improvement, and progress are available to others to spur their imagination, provide the seed for invention, and fuel competition. The authors of the Constitution, some of which were inventors in their own right, understood that a framework of laws was needed to protect those who would make the initial investment in research and development, critically needed for a new country to advance. The U.S. Constitution is the basis of legal protection of intellectual property in the U.S.

The Congress shall have the power . . . To promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries.<sup>6</sup>

As stated, the primary objective of U.S. intellectual property laws is to promote the progress of society. By making it possible for Congress to grant limited exclusive rights of patents and copyrights to discoverers of inventions and authors of creative works, the disclosure of such intellectual property to the general public was assured, mutually benefitting society and the patentee/copyright owner. The end goal was an incentive for inventors and authors to create and disclose their works, thereby building the country's IP and making the knowledge available for the public's benefit. Absence of such laws would be a deterrent to disclosure and sharing by developers who would be fearful that they would lose the commercial benefit of their creations if they could not exclude others from taking them.

This concern was addressed internationally almost a century later. In 1873, afraid their ideas would be stolen and exploited commercially in other countries, foreign exhibitors refused to attend the International Exhibition of Inventions in Vienna.<sup>7</sup> This signaled the need for international protection of intellectual property. In 1883, the Paris Convention for the Protection of Industrial Property (the Paris Convention) was born in a year in which important intellectual property came into existence: Johannes Brahms was composing his third Symphony, Robert Louis Stevenson was writing *Treasure Island*, and John and Emily Roebling were completing construction of New York's Brooklyn Bridge.<sup>8</sup> As the first international treaty on IP, the Paris Convention established categories of IP we still use today: inventions, trademarks, and industrial designs. Later in 1893, the convention merged with the Berne Convention for the Protection of Literary and Artistic Works (1886) (the Berne Convention), which protected works of authorship through copyrights, to form an international organization charged with the protection of these intangible assets, and thus, the term "intellectual property" gained further traction.<sup>9</sup> In 1967, this organization became the World Intellectual Property Organization (WIPO), located in Geneva, currently having an impressive 186 member states, a staff of over 1200 from 116 countries

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<sup>5</sup> See *supra* note 1.

<sup>6</sup> U.S. CONST. art. I, § 8, cl. 8 (providing for congressional power to promote science and arts).

<sup>7</sup> WIPO – *A Brief History*, WORLD INTELLECTUAL PROPERTY ORGANIZATION ("WIPO"), <http://www.wipo.int/about-wipo/en/history.html> (last visited Jan. 29, 2014).

<sup>8</sup> *Id.*

<sup>9</sup> *Id.*

around the world, and a mission and mandate to administer intellectual property matters recognized by the member States of the United Nations.

In the United States, the term “intellectual property” can be found as early as October 1845, in a Massachusetts Circuit Court ruling in the patent case *Davoll v. Brown*<sup>10</sup>, in which Justice Charles L. Woodbury wrote that “only in this way can we protect intellectual property, the labors of the mind, productions and interests are as much a man’s own. . .as the wheat he cultivates, or the flocks he rears.”<sup>11</sup> It was not until the establishment of WIPO in 1967, however, that the term “intellectual property” really began to be used in the United States, which at that time was not a party to the Berne Convention (the U.S. joined it in 1989), and it did not enter popular usage until passage of the Bayh-Dole Act in 1980 and after the American Patent Association changed its name to the American Intellectual Property Law Association.<sup>12</sup>

## **B. Financial and Economic Incentives for the Intellectual Property Rights**

If not protected, intellectual property has little to no value. IP’s value develops from the exclusive right to use it, or, its corollary, the right to exclude others from it. Exclusive rights granted under intellectual property laws allow creators of IP to benefit from their discoveries and creations. Non-creator-owners can similarly benefit if the IP is assigned to them expressly and under contract law. Intellectual property rights provide a financial incentive for the investment in creating intellectual property, and, in the case of patents, associated research and development costs.<sup>13</sup> In 2013, the U.S. Patent and Trademark Office claimed that the worth of intellectual property to the U.S. economy is more than \$5 trillion USD and creates employment for an estimated 18 million American people. The value of IP internationally is considered similarly high in other developed nations, such as those in the European Union.<sup>14</sup>

Economic research has shown a positive correlation between a strengthening IP system and economic growth.<sup>15</sup> Economists estimate that two-thirds of the value of corporate market values in the US can be traced to intangible assets.<sup>16</sup> While some may debate the amount of the value of intellectual property to economies, most can agree that in countries with developed or developing IP systems, revenues are generated from those systems, and furthermore, those systems most often than not result in an increase of intellectual capital, and competition is fostered.

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<sup>10</sup> *Davoll v. Brown*, 7 F.Cas. 197 (D. Mass. 1845).

<sup>11</sup> *Id.* at 199 (citing *Grant v. Raymond*, 31 U.S. 218, 219 (1832)).

<sup>12</sup> Mark A. Lemley, *Property, Intellectual Property, and Free Riding*, at 4 n. 6 (Stanford Law Sch. John M. Olin Program in Law and Econ. Working Paper No. 291, 2004), [http://philo.at/wiki/images/Lemly\\_property\\_free\\_riding.pdf](http://philo.at/wiki/images/Lemly_property_free_riding.pdf) (last visited Jan. 29, 2014).

<sup>13</sup> Doris Schroeder & Peter Singer, *Prudential Reasons for IPR Reform*, A REPORT FOR INNOVA-P2 at 6 (Univ. of Melbourne 2009), [http://www.uclan.ac.uk/research/environment/projects/assets/cpe\\_innova\\_deliverable1\\_2.pdf](http://www.uclan.ac.uk/research/environment/projects/assets/cpe_innova_deliverable1_2.pdf) (last visited June 23, 2014).

<sup>14</sup> Thomas Bollyky, *Why Chemotherapy That Costs \$70,000 in the U.S. Costs \$2,500 in India*, THE ATLANTIC, (Apr. 10, 2013, 2:47 PM), <http://www.theatlantic.com/health/archive/2013/04/why-chemotherapy-that-costs-70-000-in-the-us-costs-2-500-in-india/274847/>.

<sup>15</sup> *See supra* note 13.

<sup>16</sup> Baruch Lev, *Remarks on the Measurement, Valuation, and Reporting of Intangible Assets*, 9 FED RES. BANK OF N.Y. ECON. POL’Y REV. (2003), available at <http://www.newyorkfed.org/research/epr/03v09n3/0309levy.pdf>.

In summary, the important thing to remember about the content in the sections above is that intellectual property is different from and should not be confused in the mind with intellectual property *rights*. It is even more important to know that only through diligent, consistent, and thoughtful application of the intellectual property rights mechanisms afforded the IP owner by governments is the value of intellectual property ever realized by the owner. That is the subject of the remaining sections of this article.

## II. TYPES OF INTELLECTUAL PROPERTY

Intellectual property rights include patents, copyrights, industrial design rights/design patents, and rights in trademarks, service marks, trade dress, and, in some jurisdictions, trade secrets. There are other exclusive rights, such as circuit design rights protected by mask work rights, found in the copyright statute.<sup>17</sup> Each of these forms of intellectual property protects a distinct piece of intellectual property and is circumscribed by certain basic concepts: (1) the rights that are exclusively granted; (2) the substantive requirements for receiving that exclusivity; (3) the subject matter the exclusive rights cover; (4) the duration of rights or their term of exclusivity; and (5) the remedies for their violation.<sup>18</sup> Stemming from the U.S. Constitution, intellectual property laws are federal for patents and copyright rights. Trademark rights arise in both state and federal law, but trade secret laws are either state laws or arise under a state's common law. Outside the U.S., patent and copyright laws generally arise from treaties and conventions, such as the Paris Convention and Berne Convention. Trademark laws are generally code driven, and many countries do not have any laws protecting trade secrets at all, and if they do, they protect trade secrets under unfair competition statutes or some under treaty, such as NAFTA.

### A. Patents

Patents protect inventions, discoveries, and conceptions. How patents are granted, the formal requirements placed on the patent applicants, and the scope of patent grants vary widely between countries according to national laws and international agreements. Patents are jurisdictional, i.e., a U.S. patent addresses infringement only within the confines of the U.S. In most countries, the exclusive rights granted to a patentee are the rights to prevent others from making, using, or selling the patented invention without permission.<sup>19</sup>

#### 1. *Exclusive Rights under Patents*

In the U.S., a patent is a government-granted “limited” monopoly to the inventor to exclude others from making, using, offering for sale, or selling the patented invention within, or importing the patented invention into the U.S.<sup>20</sup> Whoever, without authority from the inventor, exercises any one of this set of exclusive rights, whether knowingly or unknowingly, infringes

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<sup>17</sup> 17 U.S.C. § 901 (West 2012).

<sup>18</sup> DONALD S. CHISUM & MICHAEL A. JACOBS, UNDERSTANDING INTELLECTUAL PROPERTY LAW, 1-3 (1992).

<sup>19</sup> *Patent Drafting Manual*, WORLD INTELLECTUAL PROPERTY ORGANIZATION (“WIPO”) at 6 (2010), [http://www.wipo.int/export/sites/www/freepublications/en/patents/867/wipo\\_pub\\_867.pdf](http://www.wipo.int/export/sites/www/freepublications/en/patents/867/wipo_pub_867.pdf).

<sup>20</sup> 35 U.S.C. § 271(a) (West 2012).

the patent.<sup>21</sup> While knowledge of the infringement is not necessary, there are two other provisions of § 271 for which knowledge is an element.<sup>22</sup> Under § 271(b), anyone who actively induces infringement of a patent is liable.<sup>23</sup> Active inducement requires that there be some knowledge of the patent and intent to infringe.<sup>24</sup> Finally, someone is liable for contributory infringement of a patent when he or she offers to sell, sells, or imports a component of a patented invention, where such component constitutes “a material part of the invention,” if he or she knows that the component is especially made or adapted for such infringement, and the component does not have “substantial noninfringing use.”<sup>25</sup>

## 2. *Inventions Qualifying for Patent under the AIA*

In the U.S., historically, the person entitled to a patent has been the first to invent, however, the America Invents Act, the first major patent law reform since 1952, which was signed into law on September 16, 2011, with all provisions becoming effective on March 16, 2013, harmonized U.S. law with other countries’ laws by changing the first-to-invent patent system to a first-to-file system/first to disclose system.<sup>26</sup> Under the America Invents Act, for patent applications filed after March 16, 2013, a person is entitled to a patent for inventions that are not: (1) already patented, described in a printed publication, in public use, on sale or otherwise available to the public prior to the date of filing of the claimed invention; or (2) described in a patent or published patent application filed prior to the date of filing of the claimed invention, which patent or application names another as inventor.<sup>27</sup> The following exceptions to (1) and (2) above are *disclosures* within twelve months of the filing date of the claimed invention either: (a) by the inventor or someone else who obtained the subject matter from the inventor if it was made by the inventor, or (b) that were prior public disclosures of the inventor.<sup>28</sup>

## 3. *Subject Matter of Patentable Inventions*

In the U.S., the subject matter of a patentable invention can be: an apparatus (e.g., something with moving parts like a pair of scissors); an article of manufacture (e.g., something without moving parts like a screwdriver); a compound (e.g., a chemical composition); a process or a method (e.g., a series of steps as part of a method or process); and an improvement of the foregoing.<sup>29</sup> There are judicial exceptions to this patent-eligible subject matter: laws of nature, abstract ideas, natural phenomena, and mathematical algorithms and formulas are not entitled to patents.<sup>30</sup>

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<sup>21</sup> *Id.*

<sup>22</sup> See, e.g., 35 U.S.C. § 271(b)-(c).

<sup>23</sup> 35 U.S.C. § 271(b).

<sup>24</sup> Global-Tech Appliances, Inc. v. SEB S.A., 131 S. Ct. 2060, 2068 (2011).

<sup>25</sup> 35 U.S.C. § 271(c).

<sup>26</sup> Leahy Smith America Invents Act of 2011, Pub. L. No. 112-29, 125 Stat. 284 (codified as amended in scattered sections of 35 U.S.C.).

<sup>27</sup> 35 U.S.C. § 102(a) (West 2012).

<sup>28</sup> *Id.* § 102(b)(1)(A)-(B), (b)(2)(A)-(B).

<sup>29</sup> 35 U.S.C. § 101 (West 2012).

<sup>30</sup> Mayo Collaborative Servs. v. Prometheus Labs., Inc., 132 S. Ct. 1289, 1293-94 (2012).

#### 4. Requirements of a Patent

An inventor is “[w]hoever invents or discovers any new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof,” and he or she “may obtain a patent therefore, subject to the conditions and requirements of [title 35].”<sup>31</sup> As stated, among the most important requirements for a patent, are usefulness and newness, that is, the invention must be novel and not known before its invention.<sup>32</sup> The third requirement is that at the time of its discovery, the invention must be non-obvious to a person skilled in the art of the invention’s technology.<sup>33</sup> In jurisdictions outside of the U.S., the non-obviousness requirement is termed as a requirement that the invention involve an inventive step sufficient to merit the patent.<sup>34</sup>

Another requirement is that the inventor publicly disclose in the patent a description of the invention, in sufficient detail to enable others to practice the invention, and set out the best mode of practicing it, i.e., teach others to use it. This is done by way of a specification that contains a written description of the invention and the manner of making and using it, sufficiently clear such that a person skilled in the art will be enabled to practice the invention.<sup>35</sup> The specification concludes with one or more claims that define the metes and bounds of the invention, which must be narrowed and limited by existing prior art.<sup>36</sup> If the patent application goes beyond the novel and non-obvious into the prior art realm, it is the job of the patent examiner at the patent office to rein in the claimed disclosure within novel and non-obvious territory.<sup>37</sup>

#### 5. Duration of Patent Term

There are various kinds of patents with their own term or duration. Utility patents protect useful inventions for 20 years from filing.<sup>38</sup> Any patent office examination to narrow the claims eats into this term.<sup>39</sup> Design patents, discussed below, protect new, original, and strictly ornamental and non-functional aspects of a design for an article of manufacture for 15 years from grant.<sup>40</sup> Plant patents, which have a term of 20 years from filing, can issue for new, distinct, invented, or discovered asexually-reproduced varieties of plant, including cultivated sports, mutants, hybrids, and newly-found seedlings, other than a tuber-propagated plants.<sup>41</sup>

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<sup>31</sup> 35 U.S.C. § 101.

<sup>32</sup> *Id.* § 102(a) (evaluating an invention’s newness); *see discussion supra* Part II.A.2.

<sup>33</sup> 35 U.S.C. § 103(a) (West 2012).

<sup>34</sup> *See* EUROPEAN PATENT CONVENTION 1973, art. 56 (revised Dec. 13, 2007), <http://www.epo.org/law-practice/legal-texts/html/epc/1973/e/ar56.html>.

<sup>35</sup> 35 U.S.C. § 112(a) (West 2012).

<sup>36</sup> *Id.* § 112(b).

<sup>37</sup> Manual on Patent Examining Procedure, ch. 2171 (9th ed. Rev. 11, Mar. 2013), *available at* <http://www.uspto.gov/web/offices/pac/mpep/s2171.html>.

<sup>38</sup> 35 U.S.C. § 154(a)(2) (West 2012).

<sup>39</sup> *See id.* § 154(b).

<sup>40</sup> 35 U.S.C. § 173 (West 2012); *see infra* Part II.B.

<sup>41</sup> 35 U.S.C. § 161 (West 2012).

## 6. *Infringement of Patents and Remedies*

To exclude others from practicing the invention, the inventor or his or her assignee must obtain a patent in each country, or, practically and for economy's-sake, in a subset of countries whose markets are of interest to him or her.<sup>42</sup> Infringement of patents requires the patentee to prove that every element of a patent claim is infringed.<sup>43</sup>

Damages are by civil action filed in federal court.<sup>44</sup> Damages awarded shall be adequate to compensate for the infringement, but no less than a reasonable royalty for the use of the patented invention, plus interest and costs.<sup>45</sup> Infringement is actionable, whether the infringer has knowledge that the infringement is happening or not.<sup>46</sup> Willful, knowing infringement, however, can result in the award of triple damages.<sup>47</sup> Injunction to prevent the violation of patent is also available.<sup>48</sup> Alleged infringers can defend themselves by proving that they do not infringe or that the patent claim asserted is invalid because it did not meet the requirements of novelty and non-obviousness at the time it was invented. Another defense is that the patent is invalid due to the inventor not having been entitled to a patent because he/she committed misconduct in the prosecution of the patent in front of the patent office, for example, by omitting known prior art, which the inventor and his or her counsel are required to bring to the attention of the patent examiner.<sup>49</sup>

The acquisition of patents and patent infringement litigation are costly, highly-specialized, and resource-intensive activities, but a patentee can be rewarded by chilling his/her competitors' practice of the invention by receiving a patent and even as early as 18 months after filing the patent application. The patent application is published 18-months after the filing the patent application, if the patent applicant, at his discretion chooses to publish it.<sup>50</sup> A prevailing patentee-litigant can be well-compensated by being granted an injunction against an infringer's further infringement and/or a damages award in the form of royalties. However, failing to act to seek and obtain a patent in a timely manner or failing to adequately cover the invention in a well-written patent application meeting all the requirements of a patent, however, can mean a loss of rights to the inventor in favor of the public domain. Likewise, failure to act to assert patent rights and file a patent infringement action within six years of the commencement of infringement can result in a loss of the right to claim damages under the equitable doctrine of laches.<sup>51</sup>

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<sup>42</sup> See *supra* note 19 and accompanying text Part II.A.

<sup>43</sup> *Cross Med. Prods. v. Medtronic Sofamor Danek, Inc.*, 424 F.3d 1293, 1311-12 (Fed. Cir. 2005) ("To infringe an apparatus claim, the device must meet all of the structural limitations.").

<sup>44</sup> 35 U.S.C. § 281 (West 2012).

<sup>45</sup> 35 U.S.C. § 284 (West 2012).

<sup>46</sup> *Fla. Prepaid Postsecondary Educ. Expense Bd. v. College Sav. Bank*, 527 U.S. 627, 645 (1999) ("Actions predicated on direct patent infringement . . . do not require any showing of intent to infringe; instead, knowledge and intent are considered only with respect to damages.").

<sup>47</sup> 35 U.S.C. § 284.

<sup>48</sup> 35 U.S.C. § 283 (West 2012).

<sup>49</sup> 35 U.S.C. § 282 (West 2012).

<sup>50</sup> 35 U.S.C. §122(b)(1), (2)(B)(i) (West 2012).

<sup>51</sup> 35 U.S.C. § 286 (West 2012).

## B. Industrial Design Rights/Design Patents

An industrial design right is an intellectual property right arising under international law that protects the ornamental or aesthetic aspects of the design of an object that are not purely utilitarian. An industrial design consists of the creation of a three-dimensional shape, configuration, or surface of an article or two-dimensional patterns, lines, or color.<sup>52</sup>

In other countries, industrial designs are protectable as a separate category from patents. Industrial designs of manufactured objects, such as automobile parts, are frequently the recipients of foreign industrial design rights and protect the investment in their creation. Generally, designs must be new or original and be designs that are “considered to be dictated exclusively by the technical function of a product.”<sup>53</sup>

The term of protection for an industrial design is about five years, with a possible renewal of up to 15 years.<sup>54</sup> Registration of an industrial design grants the right to prevent unauthorized copying, including the right to prevent all unauthorized parties from making, selling, or importing any product into which the design is incorporated.<sup>55</sup> Industrial designs are also protectable under copyright law as sculptures. In some countries, the design may be protected by both industrial design registration and copyright rights, however, some countries do not permit both industrial design and copyright protection concurrently.<sup>56</sup> In some countries, an industrial design may also be protectable under unfair competition law.<sup>57</sup> There is an entire chapter, 35 U.S.C. § 38, dedicated to the filing in the U.S. of an international design application under treaty. In the U.S., however, industrial designs are protected by design patents, which protect new, original, and ornamental designs of an article of manufacture, but only its non-utilitarian and non-functional aspects.<sup>58</sup> The U.S. would permit protection of such a design under both a design patent and under copyright law.

## C. Copyright

Copyright is an important intellectual property right, especially in the “information world” of today because it protects expression or how something is expressed. All content on the Internet, all literary works, all music, movies, photography, and art is protected by copyright rights. It is the intellectual property right mechanism that protects most of our current and contemporary technologies. Copyright throughout the world is guided by treaty, The Berne Convention, which the U.S. joined on March 1, 1989.<sup>59</sup> The discussion below, therefore, will be

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<sup>52</sup> WIPO – *Industrial Designs*, WORLD INTELLECTUAL PROPERTY ORGANIZATION (“WIPO”), <http://www.wipo.int/designs/en/> (last visited Jan. 29, 2014).

<sup>53</sup> WIPO – *About Industrial Designs*, WORLD INTELLECTUAL PROPERTY ORGANIZATION (“WIPO”), [http://www.wipo.int/designs/en/about\\_id.html](http://www.wipo.int/designs/en/about_id.html) (last visited Jan. 29, 2014).

<sup>54</sup> *Id.*

<sup>55</sup> *Id.*

<sup>56</sup> *Id.*

<sup>57</sup> *Id.*

<sup>58</sup> 35 U.S.C. § 171 (West 2012).

<sup>59</sup> WIPO – *The Berne Convention for the Protection of Literary and Artistic Works*, WORLD INTELLECTUAL PROPERTY ORGANIZATION (“WIPO”), [http://www.wipo.int/treaties/en/ip/berne/trtdocs\\_wo001.html](http://www.wipo.int/treaties/en/ip/berne/trtdocs_wo001.html) (last visited Jan. 29, 2014).

limited to U.S. law on the subject.

### ***1. The Requirements of Copyright Protection***

Copyright laws protect original works of authorship that are fixed in any tangible media.<sup>60</sup> The requirement of originality is that the work must be original to the author, i.e., that the purported author has not copied the work from another.<sup>61</sup> It follows from this that two authors who independently come up with the same writing, expressed in the same way, are each entitled to copyright rights in the same work.<sup>62</sup>

The phrase, “fixed in a tangible medium” means that the expression has been captured in a medium that is sufficiently permanent or stable such that the work can be “perceived, reproduced, or otherwise communicated for a period of more than transitory duration.”<sup>63</sup> Fixation can be best explained by example: a work written down and even broadcasted through the airwaves is considered “fixed in a tangible medium,” however the spoken, unrecorded word is not fixed in a tangible medium. The most important thing to know about fixation, though, is that copyright protection springs into existence at the moment of fixing the original work in a tangible medium – nothing else is necessary for copyright rights to exist – not even the ubiquitous copyright legend or copyright registration.<sup>64</sup>

### ***2. Subject Matter Eligible for Copyright Protection***

The subject matter of copyright can be any one of an array of intellectual properties, among them, literary works (including software source code); musical works (including accompanying words); dramatic works (including accompanying music); choreographic works; pictorial, graphic, and sculptural works (including portraits and photographs); audio visual works (including motion pictures); sound recordings; and architectural works.<sup>65</sup> Compilations, collections of existing works of authorship, such as a group of articles in a magazine, are also entitled to copyright protection, independently of the copyright in each of the articles.<sup>66</sup>

Copyright protects the expression of the work, and not the facts or ideas in the work.<sup>67</sup>

### ***3. Exclusive Rights under Copyright and Their Duration***

A bundle of exclusive copyright rights are granted to owners of copyright. Predictably, the first right is the copy right – the right to copy the work; to reproduce it. The second right is the

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<sup>60</sup> 17 U.S.C. § 102 (West 2012).

<sup>61</sup> *Feist Publ's v. Rural Tel. Serv.*, 499 U.S. 340, 345 (1991).

<sup>62</sup> *Peters v. West*, 692 F.3d 632, 633 (7th Cir. 2012) (“independent creation is a defense to copyright infringement”).

<sup>63</sup> 17 U.S.C. § 101 (West 2012); *Network LP v. CSC Holdings, Inc.*, 536 F.3d 121, 127 (2d Cir. 2008).

<sup>64</sup> *Montgomery v. Noga*, 168 F.3d 1282, 1288 (11th Cir. 1999).

<sup>65</sup> 17 U.S.C. § 102.

<sup>66</sup> 17 U.S.C. § 103 (West 2012).

<sup>67</sup> *Feist Publ's v. Rural Tel. Serv.*, 499 U.S. 340 (1991) (holding that names, towns, and telephone numbers from white pages in a phone book were uncopyrightable facts; there was no creativity in an alphabetical listing of names; and the “sweat of the brow” in creating the listing is not protected under copyright).

right to prepare derivative works based upon the work, i.e., modifications or adaptations of the copyrighted work. The third exclusive right is the right to distribute copies of the copyrighted work to the public by sale, or other transfer of ownership, or by rental, lease, or lending. The fourth right is the right to publicly perform the copyrighted work that is a literary, musical, dramatic, or choreographic work or a pantomime, motion picture or other audiovisual work. The fifth right is the right to publicly display the work that is a literary, musical, dramatic, or choreographic work or a pantomime or a pictorial, graphic, or sculptural work, including individual images of an audiovisual work. The sixth right is for sound recordings. It is the right to perform the copyrighted work publicly by digital audio transmission.<sup>68</sup> These rights are called a bundle of rights because the author may assign or license one or more of these rights and retain other rights at his or her discretion.<sup>69</sup>

The duration of copyright in the US, for works of authorship created post January 1, 1978, is the whole life of the author plus seventy years from the author's death (for joint authors, it is the life of the last surviving author).<sup>70</sup> For "works made for hire," which are discussed below, the duration of copyright is the lesser of 95 years from publication or 120 years from creation.<sup>71</sup>

#### **4. *Works Made for Hire and Copyright Assignments***

Copyright rights are owned by the author except for works made for hire, which are owned by the author's employer.<sup>72</sup> A work made for hire is defined in the definitions section of the 17 U.S.C. as a work created by an employee within the scope of his or her employment, or one of several special types of commissioned works (a work specially ordered or commissioned for use as: a contribution to a collective work, a part of an audiovisual work, a translation, a supplementary work, a compilation, an instructional text, a test, answer material for a test, or an atlas, provided that the parties expressly agree in a written instrument that the work is considered a work made for hire).<sup>73</sup> As with patent rights, copyright rights can only be assigned by a written assignment.<sup>74</sup> A savvy employer will not merely rely on the definition of "work made for hire," but instead will employ a "belt and suspenders" approach to ensure the employer's ownership of works of authorship and copyrights therein. That is, the employer will recite in its employment agreement that all works of authorship created by its employees during the course of employment are "works made for hire" and will also include proper assignment language in the employment agreement as follows: "Employee hereby assigns to Employer all rights, title, and interest in and to all works of authorship that Employee creates while in the employ of Employer and in and to all copyrights in such works of authorship." Such language will ensure that the employer owns whatever works of authorship the employee creates, without fear that a court

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<sup>68</sup> 17 U.S.C. § 106 (West 2012)

<sup>69</sup> Columbia Pictures Indus. v. Redd Horne, Inc., 749 F.2d 154, 158 (3d Cir. 1984) ("Since the rights granted by §106 are separate and distinct, and are severable from one another, the grant of one does not waive any of the other exclusive rights.").

<sup>70</sup> 17 U.S.C. § 302(a), (b) (West 2012).

<sup>71</sup> 17 U.S.C. § 302(c).

<sup>72</sup> Community for Creative Non-Violence v. Reid, 490 U.S. 730 (1989) (describing elements of what it takes to be within the scope of employment, making it a work made for hire).

<sup>73</sup> 17 U.S.C. § 101.

<sup>74</sup> 17 U.S.C. § 204(a) (West 2012).

may later rule that the employee's works of authorship are not within the definition of "works made for hire."

While assignments of copyright must be in writing, licensing is different. Only exclusive copyright licenses are required to be in writing. Non-exclusive copyright licenses may be oral and can therefore be implied. Implied license rights permit the exercise of certain rights under copyright law that arise from common usage and custom.<sup>75</sup>

### 5. *Copyright Notices and Registration*

The ubiquitous copyright notice is not required for copyright protection.<sup>76</sup> However, to avoid a defense of innocent infringement, it is a good idea to display the notice on visually-perceptible copies of the copyrighted work in locations on the work where a potential infringer will see it.<sup>77</sup> § 401(b) sets out the three elements of a proper copyright notice, an example of which is:

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1. In the U.S., the symbol © or the word "Copyright" or the abbreviation "Copyr." is the first element. Because not one of these is universally understood or accepted throughout the world, copyright owners whose works are on the Internet or sold internationally, would be advised to use both the © symbol, followed by the word "Copyright."
2. The second element is the date of first publication (for a work that will or has been published) or the date of first creation (for a work that is not and will not be published, such as source code or a writing describing a trade secret), followed by all publication or creation dates of derivative versions of the work, if any. In the example above, the first publication of the work was in 2008. It was then modified in 2009, 2010, and 2014.
3. Finally, the name of the owner of the copyright, is the third element of a proper copyright legend.<sup>78</sup>

These elements may be abbreviated if there are space limitations, such as on a photograph, a piece of jewelry, or an integrated circuit chip. In tight space, the above example might be presented as:

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<sup>75</sup> 3 M. Nimmer & D. Nimmer, *Nimmer on Copyright* § 10.03[A], at 10-36 (1989); *Effects Assocs., Inc. v. Cohen et al.*, 908 F.2d 555, 558-59 (1990) (holding that an implied license exists for a copyrighted work due to the plaintiff's conduct).

<sup>76</sup> 17 U.S.C. § 401 (West 2012) ("[A] notice of copyright as provided in this section *may* be placed on publicly distributed copies from which the work can be visually perceived.") (emphasis added).

<sup>77</sup> 17 U.S.C. § 401(d) ("If a notice of copyright . . . appears on the published copy . . . no weight shall be given to such a defendant's interposition of a defense based on innocent infringement in mitigation of actual or statutory damages.").

<sup>78</sup> 17 U.S.C. § 401(b).

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Copyright registrations are filed in the Copyright Office.<sup>79</sup> Registration is generally permissive.<sup>80</sup> § 408(a) of the United States Copyright Act states that “[a]t any time during the subsistence of the . . . term of copyright . . . , the owner of copyright or of any exclusive right in the work may obtain registration of the copyright claim . . . .” The filing of the proper Copyright Office form, a fee, and a deposit of a specimen of the copyrighted work are required for registration.<sup>81</sup> Registration, however, is a precondition to filing an action of copyright infringement.<sup>82</sup> Furthermore, significant benefits ensue from filing a copyright registration. First, a copyright registration can be recorded with the U.S. Customs and Border Protection Agency to keep pirated and counterfeit goods having copyright protection from being imported into the U.S.<sup>83</sup> Also, if registration is not made within three months after publication of the work or one month after the copyright owner learned of the infringement, the copyright owner will not be eligible to receive statutory damages or attorneys’ fees.<sup>84</sup>

## 6. *Remedies for Copyright Infringement—Damages*

Although criminal sanctions may apply in some cases, copyright enforcement is a civil matter.<sup>85</sup> Infringement requires proof of three elements: (1) ownership of a valid copyright; (2) factual copying of original elements of the copyrighted work by direct or circumstantial evidence; and (3) that the allegedly infringing work is “substantially similar” to the copyrighted work.<sup>86</sup> In the Fifth Circuit Court of Appeals, a side-by-side comparison should be made between the original and the copy to determine whether a layman would view the two works as substantially similar.<sup>87</sup> Similarity must be probative of copying.<sup>88</sup> In assessing similarity, it is important to consider whether the allegedly infringing author had access to the allegedly infringed work.<sup>89</sup> Once copying is established, an assessment should be made to determine whether the copying was substantial.<sup>90</sup> This involves looking at how much was copied and whether the copying was “qualitatively important” to the entirety of the copyrighted work.<sup>91</sup>

The remedies provided by the United States Copyright Act for proven copyright infringement include injunctions under 17 U.S.C. § 502, impounding of infringing copyrighted

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<sup>79</sup> 17 U.S.C. § 408(f) (West 2012).

<sup>80</sup> 17 U.S.C. § 408(a).

<sup>81</sup> 17 U.S.C. § 408(a).

<sup>82</sup> 17 U.S.C. § 411(a) (West 2012).

<sup>83</sup> 17 U.S.C. § 602(b) (West 2012); *see also* U.S. Customs and Border Protection, STOPFAKES.GOV, <http://www.stopfakes.gov/us-gov-agencies/cbp> (last visited Feb. 2, 2014).

<sup>84</sup> 17 U.S.C. § 412 (West 2012).

<sup>85</sup> 17 U.S.C. § 411(a).

<sup>86</sup> *Armour v. Knowles*, 512 F.3d 147, 152 (5th Cir. 2007).

<sup>87</sup> *Positive Black Talk Inc. v. Cash Money Records, Inc.*, 394 F.3d 357, 374 (5th Cir. 2004) (citing *Creations Unlimited, Inc. v. McCain*, 112 F.3d 814, 816 (5th Cir. 1997)).

<sup>88</sup> *Peters v. West*, 692 F.3d 629, 632-34 (7th Cir. 2012).

<sup>89</sup> *Id.* at 634 (“Similarity that is so close as to be highly unlikely to have been an accident of independent creation is evidence of access.”) (internal citations and quotation marks omitted).

<sup>90</sup> *R. Ready Prods., Inc. v. Cantrell*, 85 F. Supp. 2d 672, 683 (S.D. Tex. 2000).

<sup>91</sup> *Id.*

articles under 17 U.S.C. § 503, and either actual damages and profits under 17 U.S.C. § 504(b) or statutory damages under 17 U.S.C. § 504(c). An infringer of copyright is liable for (1) the copyright owner's actual damages and any additional profits from the infringer, as provided by subsection (b); or (2) statutory damages as provided by subsection (c).<sup>92</sup> To establish the profits, the copyright owner is only required to present proof of the infringer's gross revenue.<sup>93</sup> The infringer is required to prove his or her deductible expenses and the elements of profit attributable to factors other than the copyrighted work.<sup>94</sup> As for statutory damages, the copyright owner may, instead of actual damages and profits, choose statutory damages in a sum of not less than \$750 or more than \$30,000 for each work infringed upon, as the court considers just.<sup>95</sup> If the court determines that the copyright infringement was willful, the court in its discretion may increase the award of statutory damages to a sum of not more than \$150,000, but instead, if the court finds that the infringer was not aware and had no reason to believe that his or her acts constituted an infringement of copyright, the court in its discretion may reduce the award of statutory damages to a sum of not less than \$200.<sup>96</sup> In certain cases, the court may consider the infringer's belief that his or her use of the copyrighted work was a fair use under 17 U.S.C. § 107.<sup>97</sup>

## 7. *Fair Use of Copyrighted Works*

The grant of protection through copyright is a balancing act of what is fair and what is not. § 107 of the Digital Millennium Copyright Act acknowledges this by including a provision that permits copying of works that qualify as fair use within its provisions.<sup>98</sup> Fair use of another's exclusive right in a copyrighted work is assessed by evaluating four factors:

The first factor is “the purpose and character of the use, including whether such use is of a commercial nature or is for nonprofit educational expenses.”<sup>99</sup> Uses of a copyrighted work for purposes such as criticism, comment, news reporting, teaching, scholarship, or research cannot constitute copyright infringement.<sup>100</sup> This factor recognizes that a work transformative of the allegedly infringed work may be acceptable fair use. An example of a transformative work could be a work that is a parody of the work allegedly infringed. The rationale is that such a work could be considered a new work and, as such, enlarges the body of works of authorship for the benefit of society, whereas mere copying of the original work does not.<sup>101</sup>

The second factor considers “the nature of the copyrighted work,” i.e., the value (in a

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<sup>92</sup> 17 U.S.C. § 504(a) (West 2012).

<sup>93</sup> 17 U.S.C. § 504(b).

<sup>94</sup> 17 U.S.C. § 504(b).

<sup>95</sup> 17 U.S.C. § 504(c)(1).

<sup>96</sup> 17 U.S.C. § 504(c)(2).

<sup>97</sup> 17 U.S.C. § 504(c)(2); *see, e.g.*, Digital Millennium Copyright Act, 17 U.S.C. § 107 (West 2012).

<sup>98</sup> *See* 17 U.S.C. § 107.

<sup>99</sup> 17 U.S.C. § 107(1).

<sup>100</sup> 17 U.S.C. § 107.

<sup>101</sup> *Campbell v. Acuff-Rose Music, Inc.*, 510 U.S. 569, 578-79 (1994).

creative sense) of the work that was infringed.<sup>102</sup> This factor recognizes that facts and ideas are not protectable; only their expression is. This factor also considers that there are works that naturally have “thin” copyright protection.<sup>103</sup> An example could be a form document requesting “Print Name,” “Address,” “Phone Number,” etc. or an operations manual that states “turn valve handle 3 times, read dial, and verify that reading does not exceed 1000 degrees.”

The third evaluates the amount and substantiality of the portion [of the work] used in relation to the copyrighted work as a whole.”<sup>104</sup> *De minimis* copying is much more likely to be considered fair use as opposed to wholesale copying of a work unless, of course, the small amount copied is the most important part of the work infringed upon.<sup>105</sup>

The fourth factor is an inquiry into “the effect of the use upon the potential market for or value of the copyrighted work.”<sup>106</sup>

#### **D. Trademarks, Service Marks, and Trade Dress**

Trademarks and service marks are recognizable words, designs, or expressions that identify and distinguish products or services to be of a particular source from those of others.<sup>107</sup> The purpose of trademark law is to assist consumers in identifying the source or origin of products or services and thereby intimate to the consumer the level of quality of a product.<sup>108</sup>

##### **1. *Subject Matter of Trademark Protection***

A trademark and a service mark can be a word, phrase, logo, sound, color, and even an odor that identifies or distinguishes goods or services from their manufacturer or vendor from those of other manufacturers or vendors and indicate the goods’ or services’ source in the marketplace, even if their source is unknown.<sup>109</sup> Similarly, trade dress generally refers to characteristics of the visual appearance of a product, its packaging, or even a building’s decor, including size, shape, color, graphics, and even sales techniques, indicating to a consumer that what is offered is from a single source.<sup>110</sup> The shape of a bottle of vodka; the shape, color, and arrangement of

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<sup>102</sup> 17 U.S.C. § 107(2).

<sup>103</sup> *Acuff-Rose Music, Inc.*, 510 U.S. at 586 (“This factor calls for recognition that some works are closer to the core of intended copyright protection than others.”).

<sup>104</sup> 17 U.S.C. § 107(3).

<sup>105</sup> See *Harper & Row, Publ’rs, Inc. v. Nation Enters.*, 471 U.S. 539, 565 (1985).

<sup>106</sup> 17 U.S.C. § 107(4); see also *Acuff-Rose Music, Inc.*, 510 U.S. at 590 (this factor requires courts to consider “whether unrestricted and widespread conduct of the sort engaged in by the defendant . . . would result in a substantially adverse impact on the potential market” for the original) (internal citations omitted).

<sup>107</sup> See Federal Trademark Act (the “Lanham Act”), 15 U.S.C. § 1127 (West 2012).

<sup>108</sup> See *Am. Steel Foundries v. Robertson*, 269 U.S. 372, 380 (1926). Even small children recognize the golden arches logo of McDonalds, and even the least perceptive of us recognize the level of quality associated with beverages marked with the Coca-Cola trademark as opposed to those that are the local supermarket’s generic brand of cola.

<sup>109</sup> 15 U.S.C. § 1127.

<sup>110</sup> *Wal-Mart Stores, Inc. v. Samara Bros., Inc.*, 529 U.S. 205, 206 (2000) (“[T]he very purpose of attaching a

the materials in a line of shoes; and a brightly-colored festive building decor can each be protectable trade dress.<sup>111</sup> What is not protectable under either trademark or trade dress, however, are the functional aspects of the aforementioned bottle, shoes, and building.<sup>112</sup>

## 2. *Rights in Trademarks*

Under U.S. law, trademarks, service marks, and trade dress are legally protected and regulated by federal statute under the Lanham Act.<sup>113</sup> Trademark and trade dress rights protect consumers who might purchase a product under the mistaken belief that it is from a certain manufacturing vendor when, in reality, it is from a different vendor.<sup>114</sup> A trademark may be located on marketing materials, such as a sign, packaging, label, or voucher, or on the product itself.<sup>115</sup>

In the U.S., rights in marks are garnered under common law, though mere use of the mark in commerce (i.e., registration) is not required. “Common law rights arise from actual use of a mark and may allow the common law user to successfully challenge a registration or application.”<sup>116</sup>

*Lucent Information Management v. Lucent Technologies* sets out a four-part test to determine whether a mark has garnered common law protection in a market by measuring the market penetration of a trademark. The test considers (1) sales volume of the trademarked product; (2) growth trends in the geographic area; (3) the ratio of actual purchasers of the product as compared to the number of potential customers; and (4) the amount of product advertising in the area.<sup>117</sup>

## 3. *Protection of Trademarks and Their Registration*

Marks may best be protected by registering with the United States Patent and Trademark Office (USPTO). Generally speaking, a mark can be registered with the USPTO if the mark does not resemble an already-registered mark or a previously-used mark (under common law) if it is likely to create confusion in the marketplace with regard to the source of the goods or services.<sup>118</sup> Likelihood of confusion can arise when the same mark, or a or similarly sounding or looking mark, is used on the same or similar goods or services to those the trademark’s owner offers under their mark.

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particular word to a product, or encasing it in a distinctive package, is most often to identify the product’s source.”); *see also* *Two Pesos, Inc. v. Taco Cabana, Inc.*, 505 U.S. 763, 764 n.1 (1992).

<sup>111</sup> *Two Pesos, Inc.*, 505 U.S. at 765-66 (holding “trade dress [is] protected if it [is] either [ ] inherently distinctive or [ ] acquire[s] a secondary meaning . . .”).

<sup>112</sup> *See Kellogg Co. v. Nat’l Biscuit Co.*, 305 U.S. 111, 122 (1938) (denying trade dress protection for the pillow shape of Kellogg’s Shredded Wheat cereal because it was held to be functional).

<sup>113</sup> *See* 15 U.S.C. § 1127.

<sup>114</sup> *See Weil Ceramics & Glass, Inc. v. Dash*, 878 F.2d 659, 672 (3d Cir. 1989).

<sup>115</sup> *See* 15 U.S.C. § 1127 (definition of the term “use in commerce”).

<sup>116</sup> The U.S. Patent and Trademark Office, *Frequently Asked Questions about Trademarks, What are “common law” rights?*, [http://www.uspto.gov/faq/trademarks.jsp#\\_Toc275426712](http://www.uspto.gov/faq/trademarks.jsp#_Toc275426712) (last visited Feb. 1, 2014).

<sup>117</sup> *Lucent Info. Mgmt. Inc. v. Lucent Techs., Inc.*, 186 F.3d 311, 317 (3d Cir. 1999) (internal citation omitted).

<sup>118</sup> 15 U.S.C. §§ 1052(d), 1053 (West 2012).

The first person to use a mark in a trademark sense—to identify to customers that he or she is the source of the goods or services—may apply for trademark or service mark registration.<sup>119</sup> To file for trademark or service mark registration, the owner must register the mark in an International Class as set out by The International Classification of Goods and Services for the Purposes of the Registration of Marks, which was established by treaty to classify goods and services for the purpose of trademark registration.<sup>120</sup> Use of the Nice Classification system is mandatory for the national registration of marks in countries that are a party to the Nice Agreement.<sup>121</sup>

Authentic English versions of the Nice Classification are published online by WIPO.<sup>122</sup> Under this classification system, service marks registered for services related to scientific equipment, including computer, computer hardware, and computer software are classified under International Class 42, and trademarks registered for software and electronic products are classified under International Class 9.

In the United States, the registration process requires the filing of an application online and takes six to twelve months to achieve registration, provided there are no applications on file for the same or similar marks or marks in use about which the trademark office is made aware.<sup>123</sup> The registration process may include the requirement that the mark's applicant disclaim unregisterable components of the mark, such as “Hamburgers” in the mark “ACME Hamburgers” to market the sale of hamburgers.<sup>124</sup> If, upon examination, the mark is deemed by the trademark examiner to be entitled to registration and all requirements are met, the mark will be published in the Official Gazette of the Patent and Trademark Office.<sup>125</sup> Anyone—presumably someone who becomes aware of the filing for registration, typically through a watch service notice, but perhaps just by monitoring the uspto.gov website for trademark applications filed—who believes he or she would be damaged by the registration of the published mark has thirty days from its date of publication to file an opposition to the registration of the mark.<sup>126</sup> If a mark is opposed, the mark owner's options are to fight the opposition and ultimately convince the trademark office of his or her priority over the challenger, or to withdraw the application.<sup>127</sup> Unless there is an opposition, however, the mark will be registered.<sup>128</sup> If the mark is registered, challenging the mark is more difficult, but can be done under the Lanham Act's cancellation procedure.<sup>129</sup> Registered marks can be challenged by the owner of a famous mark who believes

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<sup>119</sup> *George & Co. v. Imagination Entm't Ltd.*, 575 F.3d 383, 400 (4th Cir. 2009).

<sup>120</sup> The U.S. Patent and Trademark Office, *Nice Agreement Tenth Edition—General Remarks, Class Headings and Explanatory Notes-Version 2012*, <http://www.uspto.gov/trademarks/notices/international.jsp> (last visited Feb. 2, 2014).

<sup>121</sup> WIPO – *About the NCL*, WORLD INTELLECTUAL PROPERTY ORGANIZATION (“WIPO”), [http://www.wipo.int/classifications/nice/en/about\\_the\\_ncl/preface.html](http://www.wipo.int/classifications/nice/en/about_the_ncl/preface.html) (last visited Feb. 2, 2014).

<sup>122</sup> See *List of Goods and Services by Class Order*, WORLD INTELLECTUAL PROPERTY ORGANIZATION (“WIPO”), <http://web2.wipo.int/nicepub/edition-20140101/taxonomy/#> (last visited Feb. 2, 2014).

<sup>123</sup> 15 U.S.C. § 1051 (West 2012).

<sup>124</sup> 15 U.S.C. § 1056 (West 2012).

<sup>125</sup> 15 U.S.C. § 1062(a) (West 2012).

<sup>126</sup> 15 U.S.C. § 1063(a) (West 2012).

<sup>127</sup> 15 U.S.C. § 1063(a).

<sup>128</sup> 15 U.S.C. § 1063(b).

<sup>129</sup> 15 U.S.C. § 1064 (West 2012).

the mark creates a likelihood of dilution of his or her famous mark.<sup>130</sup> Registration can also be challenged on grounds that the mark has become generic for goods or services,<sup>131</sup> is functional,<sup>132</sup> has been abandoned, or because the registration was obtained fraudulently.<sup>133</sup> Registration of a mark or a trade dress constitutes constructive notice nation-wide of the owner's exclusive rights in the mark or trade dress.<sup>134</sup> The registered mark's owner has incontestable rights to the mark after five consecutive years of continuous use in commerce on goods or services.<sup>135</sup> In fact, the registration is conclusive evidence of the validity of the mark, the registration of the mark, the registrant's ownership of the mark, and of the registrant's exclusive right to use the registered mark in commerce.<sup>136</sup>

In addition to rights under federal law for marks used in interstate commerce in the U.S., there are trademark rights under state law. In Texas the requirements for state trademark registration are in Chapter 16 of the Texas Business and Commerce Code<sup>137</sup> and title 1 chapter 93 of the Texas Administrative Code.<sup>138</sup>

There are also (a) international trademark rights in over 200 countries with individual national trademark laws; (b) rights under treaties to which the U.S. is a party, such as the Madrid Protocol, which yields an International Registration for a trademark; and (c) rights under agreements among countries, which permit the filing of a single trademark application for registration in all of those countries, such as the Community Trade Mark (CTM). The U.S. subscribes to the Madrid Protocol.<sup>139</sup> The CTM provides protection of the mark in all of the member states of the European Union.<sup>140</sup>

#### **4. Duration of Trademark Registrations**

A United States trademark registration remains valid as long as the mark is used in commerce, provided the required affidavits of use are filed and the required fees are paid. Specifically, United States registrations for trademarks are good for ten years, provided that the registrant files affidavits of continued use within the one-year period immediately preceding the expiration of six years following the date of registration or the date of the publication and within the one-year period immediately preceding the expiration of ten years following the date of registration, and each successive ten-year period following the date of registration.<sup>141</sup> The

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<sup>130</sup> 15 U.S.C. § 1051; *see discussion infra* at Section II.D.5 for a description of famous marks.

<sup>131</sup> *See discussion infra* Section II.D.5.

<sup>132</sup> *See discussion supra* Section II.D.1.

<sup>133</sup> 15 U.S.C. § 1064(3).

<sup>134</sup> 15 U.S.C. § 1072 (West 2012).

<sup>135</sup> 15 U.S.C. § 1065 (West 2012).

<sup>136</sup> 15 U.S.C. § 1115(b) (West 2012).

<sup>137</sup> TEX. BUS. & COM. CODE §§ 16.001-16.107 (West 2012).

<sup>138</sup> *See* 1 TEX. ADMIN. CODE § 93 (West 2012); *see also*, Texas Secretary of State, *Trademarks and Service Marks*, <http://www.sos.state.tx.us/corp/tradepatents.shtml> (last visited Feb. 2, 2014).

<sup>139</sup> *See* 15 U.S.C. § 1141, 1141(a)-1141(n) (West 2012) (discussing Madrid Protocol provisions).

<sup>140</sup> *Fact Sheets—Types of Protection—Community Trade Mark*, INT'L TRADEMARK ASS'N, <http://www.inta.org/TrademarkBasics/FactSheets/Pages/CommunityTradeMarkFactSheet.aspx> (last visited Feb. 2, 2014).

<sup>141</sup> 15 U.S.C. § 1058(a)(1)-(2) (West 2012).

Community Trademark in Europe also has an initial registration period of ten years from the date of filing the CTM application.<sup>142</sup>

### 5. ***Strength of Trademarks***

When we discuss selecting a trademark or service mark, we should consider the strength of the mark we select. Marks are graded by their strengths: Famous, Coined, Arbitrary, Suggestive, Descriptive, and Generic. Examples of the strongest, most famous marks are “McDonalds” and “Coca-Cola.” Owners of such marks are able to keep others from diluting their mark.<sup>143</sup> Dilution is a trademark concept that gives owners of famous marks standing to forbid others from using a mark similar to their famous mark on goods or services in a way that would lessen the famous mark’s distinctiveness, regardless of whether such goods or services (1) are not the same as the mark’s owner’s goods or services, or (2) do not compete with and have little connection with, those of the trademark owner.<sup>144</sup> For example, in *Quality Inns International, Inc. v. McDonald’s Corp.*, McDonald’s was able to block the use of the mark “McSleep” for hotel services by convincing the court that its mark was famous.<sup>145</sup>

Coined marks are the next strongest. Coined marks are words that have no dictionary meaning, such as “Exxon” or “Kodak.”<sup>146</sup> Companies spend a lot of money trying to come up with coined trademarks because they are considered so strong. The next category of trademarks are arbitrary marks, which are words used as marks out of context, for example, “Apple” for computers or musical recordings and “Camel” for cigarettes.<sup>147</sup> The next strength category is suggestive. Suggestive marks suggest the product or its qualities, such as “Coppertone” for sunscreen.<sup>148</sup> Descriptive is the next category. Descriptive marks are the weakest marks and describe the product or identify a characteristic of the product.<sup>149</sup> An example might be the use of the word “Hamburger” in commerce as a mark to sell hamburgers. It is unlikely that any trademark office would allow the word “Hamburger” to be taken out of the lexicon of common usage in favor of the exclusive use of a single owner. As such, descriptive marks have no strength until they survive a lengthy period of existence in the marketplace and achieve what is called “secondary meaning” apart from the goods/services described.<sup>150</sup> An example of a mark that has achieved secondary meaning is “Holiday Inn” for hotel services. Generic is the last category, and marks in this category have no strength. Generic marks are marks that have fallen into the public domain, such as “formica” or “nylon,” words which were once trademarks, but lost their

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<sup>142</sup> See *supra* note 140, INT’L TRADEMARK ASS’N, *Community Trade Mark*.

<sup>143</sup> 15 U.S.C. § 1125(c)(2)(B) (West 2012).

<sup>144</sup> 15 U.S.C. § 1125(c)(2)(B).

<sup>145</sup> 695 F. Supp. 198, 221 (D. Md. 1988).

<sup>146</sup> *Tumblebus Inc. v. Cranmer*, 399 F.3d 754, 761, n. 7 (6th Cir. 2005).

<sup>147</sup> *Id.* at 761 n. 6 (citing *Champions Golf Club, Inc. v. The Champions Golf Club, Inc.*, 78 F.3d 1111, 1117 (6th Cir. 1996)).

<sup>148</sup> *Id.* at 761 n. 5 (citing *Induct-O-Matic Corp. v. Inductotherm Corp.*, 747 F.2d 358, 362 (6th Cir. 1984)).

<sup>149</sup> *Id.* at 761 n. 8 (citing *Nartron Corp. v. STMicroelectronics, Inc.*, 305 F.3d 397, 404 n. 7 (6th Cir. 2002), *cert. denied*, 538 U.S. 907 (2003)).

<sup>150</sup> *Id.* at 761 n. 8 (citing *Abercrombie & Fitch Stores, Inc. v. Am. Eagle Outfitters, Inc.*, 280 F.3d 619, 640 n. 14 (6th Cir. 2002)).

protection due to their owners' failure to maintain such marks' strengths.<sup>151</sup>

A trademark owner must strive to protect his or her marks in order to maintain their value. Among the most important things a trademark owner can do to maintain a mark's strength are: (1) consistently police the mark and require that infringers cease and desist uses of the mark itself or marks that are similar-sounding or looking; (2) use the mark properly, i.e., in a trademark sense; and (3) provide notice of registration to consumers and others who would infringe the mark. Policing the mark to become aware of another's use of it or similar marks on similar goods or services is imperative because, as mentioned above, mere use of a mark garners rights in it under the common law.<sup>152</sup> Under the equitable defense of "laches," failure to act against an infringer will erode the owner's right to use the mark exclusively.<sup>153</sup> The following explanation, with cites to Texas and Fifth Circuit cases, is instructional and informative.

"Laches" is defined as an inexcusable delay that results in prejudice to a defendant.<sup>154</sup> The claim can be raised as an equitable defense available for those alleged infringers who lack the requisite "bad faith intent to capitalize on the markholder's [goodwill]."<sup>155</sup> Thus, to establish a "laches" defense, the defendant has the burden to show: "(1) [plaintiff's] delay in asserting one's trademark rights; (2) [plaintiff's] lack of excuse for the delay, and (3) undue prejudice to the alleged infringer caused by the delay."<sup>156</sup> In so analyzing the defense, courts in the Fifth Circuit take a "totality of the circumstances" approach by making factual inquiries regarding "the combined effect of the [p]laintiff's delay and the prejudice resulting to the [d]efendant[ ]."<sup>157</sup> "Factual insufficiencies in any one of the three prongs will prove fatal to the defendant's assertion of the affirmative defense."<sup>158</sup>

Policing requires the owner to initiate efforts to become aware of others' uses of its marks and then acting on that knowledge. Efforts should include: (a) looking out for uses of the mark online, in magazines, or in other sources of content; (b) sending cease and desist letters to have the infringer get off the mark; (c) contracting a watch service to report whenever a third party attempts to file for registration of the mark itself or a similar looking or sounding mark; and (d) filing an opposition, notice, or cancellation action against the attempted registration in the

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<sup>151</sup> See *supra* note 140, *Community Trade Mark*, INT'L TRADEMARK ASS'N; see also *Fact Sheets—Protecting a Trademark—Loss of Trademark Rights*, INT'L TRADEMARK ASS'N, <http://www.inta.org/TrademarkBasics/FactSheets/Pages/LossofTrademarkRightsFactSheet.aspx> (last visited February 2, 2014).

<sup>152</sup> See discussion *supra* at Section II.D.2.

<sup>153</sup> Tom Jacks & John Sokatch, *Good Things Do Not Always Come to Those Who Wait: The Use of the Laches Defense in 5<sup>th</sup> Circuit Trademark Litigation*, The Intellectual Property Business Blog by Chalker Flores, LLP (April 16, 2013), <http://chalkerflores.wordpress.com/2013/04/16/the-use-of-the-laches-defense-in-5th-circuit-trademark-litigation-2/>.

<sup>154</sup> *Id.* (citing *Abraham v. Alpha Chi Omega*, 796 F. Supp. 2d 837, 845 (N.D. Tex. 2011)).

<sup>155</sup> *Id.* (citing *Bd. of Supervisors for La. State Univ. Agric. & Mech. Coll. v. Smack Apparel Co.*, 550 F.3d 465, 490 (5th Cir. 2008)).

<sup>156</sup> *Id.* (citing *Smack Apparel Co.*, 550 F.3d at 489–90).

<sup>157</sup> *Id.* (citing *New Century Fin., Inc. v. New Century Fin. Corp.*, No. C-04-437, 2005 WL 2453204, at \*33 (S.D. Tex. Oct. 4, 2005)).

<sup>158</sup> *Id.*

trademark office (provided the filer is certain he or she has prior rights).<sup>159</sup>

Using the mark properly requires that the trademark owner him or herself use (and police the use of) the mark as an adjective rather than as a noun, e.g., “Kleenex tissues,” rather than “a Kleenex.”<sup>160</sup> Also, proper use means giving notice of ownership and registration through a “trademark attribution statement” in close proximity to the appearance of the mark.<sup>161</sup> A trademark attribution statement reads as follows:

Acme and the Acme logo are trademarks owned by Acme Company, Inc. and are registered in the U.S. Patent and Trademark Office and may be registered in other countries.

Giving notice of registration or intended registration can also be accomplished by using the symbol ® with marks that have achieved registration in the jurisdiction in which they are being used or the symbol ™ (in the U.S. only) for marks in which common law rights are asserted (i.e., those that have not been registered) or those for which trademark registration is pending.<sup>162</sup> Very best practices would have the ® (or ™) symbol used on each and every appearance of a mark in text, but best practices and practicality would have such symbols appear next to the mark when it appears in the title of a document and only in the first appearance of the mark within the text of the document.<sup>163</sup>

Failure to give such notice of registration (either through symbols or trademark attribution statement) will result in no profits or damages recovery for the plaintiff of a trademark infringement suit.<sup>164</sup>

## **6. *Trademark Infringement and Remedies***

Trademark infringement occurs by the non-registrant (1) using in commerce the registered mark in connection with the sale, offering for sale, distribution, or advertising of goods or services when such use is likely to cause confusion, mistake, or deception; or (2) applying a reproduction, copy, or counterfeit of the registered mark onto labels, signs, packaging, or advertisements intended to be used in commerce in connection with the sale, offering for sale, distribution, or advertising of goods or services in a way likely to cause confusion, mistake, or deception.<sup>165</sup>

To ensure that another’s trademark is not infringed upon, the selection of a new, desired

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<sup>159</sup> *Fact Sheets—Protecting a Trademark—Loss of Trademark Rights*, INT'L TRADEMARK ASS'N, <http://www.inta.org/TrademarkBasics/FactSheets/Pages/LossofTrademarkRightsFactSheet.aspx>. (last visited Feb. 2, 2014).

<sup>160</sup> *Id.*

<sup>161</sup> 15 U.S.C. § 1111 (West 2012).

<sup>162</sup> 15 U.S.C. § 1111.

<sup>163</sup> *A Guide to Proper Trademark Use*, INT'L TRADEMARK ASS'N, [http://www.inta.org/Media/Documents/2012\\_TMUseMediaInternetPublishing.pdf](http://www.inta.org/Media/Documents/2012_TMUseMediaInternetPublishing.pdf) (last visited Feb. 2, 2014).

<sup>164</sup> 15 U.S.C. § 1111.

<sup>165</sup> 15 U.S.C. § 1114(1) (West 2012).

mark requires that a trademark search be performed to discover whether the mark is available. Trademark searches are performed by vendors that provide such services and should be analyzed by experienced trademark attorneys who can properly advise and render written opinions as to the availability of a new mark. These searches would best be performed prior to an investment in marketing collateral, literature, signs, packaging, and websites displaying the mark.

In the United States, the registered trademark owner's uncontested rights can be enforced by way of an action for trademark infringement.<sup>166</sup> Unregistered trademark rights may be enforced pursuant to the common law tort of passing off. Generally speaking, a mark's owner can exclude others from using the owner's mark on goods or services that create actual confusion or a likelihood of confusion in the marketplace as to the source of the goods or services.<sup>167</sup> The factors considered in establishing a likelihood of confusion are: (1) the strength of the mark that was registered first; (2) relatedness of the goods and services; (3) the similarity of the marks; (4) evidence of actual confusion; (5) marketing channels used; (6) likely degree of purchaser care; (7) the intent of the defendant in selecting the mark; and (8) likelihood of expansion of the product lines.<sup>168</sup>

For a successful trademark infringement action, the plaintiff is entitled to the defendant's profits, any damages sustained by the plaintiff, and the costs of the action, as determined by the court.<sup>169</sup> For successful actions involving counterfeit marks, the court may award the greater of the amount of profits or the amount of damages.<sup>170</sup> In such cases, the plaintiff may opt for statutory damages instead of actual damages and profits in the amount of not less than \$1000 or more than \$200,000 per counterfeit mark per type of goods or services sold, offered for sale, or distributed.<sup>171</sup> If the court finds that use of the counterfeit mark was willful, the court can award not more than \$2,000,000 per counterfeit mark per type of goods or services sold, offered for sale or distributed.<sup>172</sup> Violations involving the use of a counterfeit mark in connection with the sale, offering for sale, or distribution of goods or services are also eligible upon *ex parte* application for an order providing for the seizure of goods and counterfeit marks, the means of making such marks, and the records related to the violation.<sup>173</sup> Such seizures involve armed federal marshals who perform raids of warehouses and other storage locations to seize such items.<sup>174</sup>

## E. Trade Secrets

Unlike copyright and patents, there is no registration scheme for the protection of trade secrets. Trade secrets are not publicly available, and there are no government-granted exclusive

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<sup>166</sup> 15 U.S.C. § 1114.

<sup>167</sup> 15 U.S.C. § 1114(1)(a).

<sup>168</sup> *Leelanau Wine Cellars, Ltd. v. Black & Red, Inc.*, 502 F.3d 504, 515 (6th Cir. 2007).

<sup>169</sup> 15 U.S.C. § 1117(a) (West 2012).

<sup>170</sup> 15 U.S.C. § 1117(b).

<sup>171</sup> 15 U.S.C. § 1117(c).

<sup>172</sup> 15 U.S.C. § 1117(d).

<sup>173</sup> 15 U.S.C. § 1116(d) (West 2012).

<sup>174</sup> See 15 U.S.C. § 1116(d) (providing that the court may grant an order for the seizure of goods and counterfeit marks involved).

rights for trade secrets. Anyone can independently create the same trade secret information and benefit from it. Information and ideas that are not otherwise protectable by copyrights or patents, are protected by trade secret laws.

### **1. Trade Secret Protection in the U.S. and EU**

In the United States, trade secrets are protected by state law, the common law, and federal law. All states, except for New York, Massachusetts, and North Carolina have enacted a version of the Uniform Trade Secrets Act (“UTSA”), making it the main statute under which trade secrets are protected.<sup>175</sup> Massachusetts, however, has introduced the UTSA in the form of House Bill 27.<sup>176</sup> New York relies on its common law for trade secret protection.<sup>177</sup> North Carolina has enacted a modified version of the UTSA with many of its key principles.<sup>178</sup> Texas enacted its version of the Uniform Trade Secret Act effective September 1, 2013.<sup>179</sup> Texas has a criminal statute as well.<sup>180</sup> The U.S. also has a federal law to protect trade secrets, the Economic Espionage Act of 1996, found at 18 U.S.C. §§ 1831–1839.

Many countries, including, remarkably, most countries in Europe, do not have specific trade secrets laws. In such jurisdictions, trade secret owners must rely on protection under unfair competition laws and tort laws, file actions under breach of contract actions, and deal with a patchwork of fragmented laws found in labor, industrial property, and criminal codes.<sup>181</sup>

This study recommends that the EU Commission establish an initiative around trade secrets because it would foster economic growth, competitiveness, and innovation in the EU single market.<sup>182</sup> Among other things, such an initiative will, in the future, provide a uniform trade secret definition.<sup>183</sup>

### **2. Definition of “Trade Secret”**

Trade secrets have been described as the “most intangible among intangible assets.”<sup>184</sup> One classic trade secret is the Coca-Cola formula and the recipe for which is highly valuable. In the United States, there are various definitions of what is a trade secret. The states whose trade secret law is guided by the common law, which until September 1 of 2013 included Texas, rely on the definition in the Restatement First of Torts Section 757. There, a trade secret is defined as “any

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<sup>175</sup> See *Trade Secrets Act*, UNIFORM LAW COMM’N, <http://www.uniformlaws.org/Act.aspx?title=Trade%20Secrets%20Act> (last visited Feb. 2, 2014).

<sup>176</sup> *Id.*

<sup>177</sup> See Michael J. Hutter, *The Case for Adoption of a Uniform Trade Secrets Act in New York*, 10 ALB. L.J. SCI. & TECH. 1, 6 (1999).

<sup>178</sup> Richard Stim, *North Carolina Trade Secret Law*, NOLO LAW FOR ALL, <http://www.nolo.com/legal-encyclopedia/north-carolina-trade-secret-law.html> (last visited Feb. 2, 2014); *see also* N.C. GEN. STAT. §§ 66-152.

<sup>179</sup> Texas Uniform Trade Secrets Act § 134A (2013).

<sup>180</sup> TEX. PENAL CODE § 31.05 (West 2013).

<sup>181</sup> *Study on Trade Secrets and Confidential Business Information in the Internal Market*, EUROPEAN COMM’N, at 151 (April 2013), [http://ec.europa.eu/internal\\_market/ipenforcement/docs/trade-secrets/130711\\_final-study\\_en.pdf](http://ec.europa.eu/internal_market/ipenforcement/docs/trade-secrets/130711_final-study_en.pdf).

<sup>182</sup> *Id.* at 151.

<sup>183</sup> *Id.* at 154.

<sup>184</sup> *Id.* at 1.

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.”<sup>185</sup>

Under the Texas UTSA, a trade secret is defined as:

information, including a formula, pattern, compilation, program, device, method, technique, process, financial data, or list of actual or potential customers or suppliers, that:

derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use; and

is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.<sup>186</sup>

The Economic Espionage Act has its own definition:

“trade secret” means all forms and types of financial, business, scientific, technical, economic, or engineering information, including patterns, plans, compilations, program devices, formulas, designs, prototypes, methods, techniques, processes, procedures, programs, or codes, whether tangible or intangible, and whether or how stored, compiled, or memorialized physically, electronically, graphically, photographically, or in writing if—

(A) the owner thereof has taken reasonable measures to keep such information secret; and

(B) the information derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable through proper means by, the public.<sup>187</sup>

In summary, information can be protected as a trade secret if it is not public, it derives its value from not being generally known, and as long as it is maintained as secret by its owner.<sup>188</sup> Aside from statutory mandates, trade secret doctrine has developed from two well-established principles: (1) a property interest in secret information; and (2) a duty to respect the confidentiality of trade secrets. In short, if a party regards information they are sharing as confidential, its treatment by a recipient should be that which the recipient would give its own information of a similar nature.

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<sup>185</sup> RESTATEMENT (FIRST) OF TORTS § 757 cmt. b (1939).

<sup>186</sup> Texas Uniform Trade Secrets Act § 134A.002(6).

<sup>187</sup> Economic Espionage Act of 1996, 18 U.S.C. § 1839(3) (West 2012).

<sup>188</sup> See Texas Uniform Trade Secrets Act § 134.002(6); see also 18 U.S.C. § 1839(3).

### 3. *Protection of Trade Secrets*

As can be seen above in the definitions of trade secret in the UTSA and the EEA, the way the owner protects the trade secret from being known is very important. In determining whether to accord information status and protection as a trade secret, courts will look at the steps a trade secret owner has taken to protect the alleged trade secret.<sup>189</sup> If the owner is lax in how he or she keeps the information out of the public domain, judges are more likely to be receptive to a challenge of its trade secret status.<sup>190</sup> The best way to protect a trade secret is not to disclose it, but that is not always possible; sometimes information must be shared in conducting business.<sup>191</sup> The next best way to protect a trade secret is to use confidentiality agreements and limit access to the information to those who have a need to know.<sup>192</sup> The following are some of the best practices to follow to successfully protect trade secrets and confidential or proprietary information:

1. Make employees and third parties sign confidentiality agreements before having access to the information;
2. Disclose the information internally or externally solely on a need to know basis;
3. Mark information as confidential or trade secret and proprietary; and
4. Safeguard the tangible embodiments of the information in a secure, restricted-access environment. If the trade secret is in physical form, keep it under lock and key. If it is in electronic form, keep it in a password protected/segregated computer system.<sup>193</sup>

### 4. *Duration of Trade Secret Protection*

A trade secret is protected as long as it is maintained as a trade secret. Once public, a trade secret is no longer a trade secret.<sup>194</sup> In fact, it becomes part of the public domain, available to be used by anyone.<sup>195</sup> The result is that the former trade secret will no longer provide a competitive advantage to its owner because everyone else can use it to their benefit.<sup>196</sup>

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<sup>189</sup> Global Water Grp., Inc. v. Atchkey, 244 S.W.3d 924, 928 (Tex. App.—Dallas 2008, pet. denied).

<sup>190</sup> *Id.*

<sup>191</sup> See *supra* note 181, *Study on Trade Secrets and Confidential Business Information in the Internal Market*, EUROPEAN COMM’N.

<sup>192</sup> *Id.*

<sup>193</sup> *Id.*

<sup>194</sup> Texas Uniform Trade Secrets Act § 134A.002(6).

<sup>195</sup> § 134A.002(6).

<sup>196</sup> § 134A.002(6).

### 5. *Trade Secret Misappropriation*

Trade secrets are not infringed, but rather misappropriated.<sup>197</sup> Misappropriation amounts to theft.<sup>198</sup> The Texas Uniform Trade Secrets Act defines “Misappropriation” as:

- (A) acquisition of a trade secret of another by a person who knows or has reason to know that the trade secret was acquired by improper means; or
- (B) disclosure or use of a trade secret of another without express or implied consent by a person who:
  - (i) used improper means to acquire knowledge of the trade secret;
  - (ii) at the time of disclosure or use, knew or had reason to know that the person’s knowledge of the trade secret was:
    - (a) derived from or through a person who had utilized improper means to acquire it;
    - (b) acquired under circumstances giving rise to a duty to maintain its secrecy or limit its use; or
    - (c) derived from or through a person who owed a duty to the person seeking relief to maintain its secrecy or limit its use; or
  - (iii) before a material change of the person’s position, knew or had reason to know that it was a trade secret and that knowledge of it had been acquired by accident or mistake.<sup>199</sup>

““Improper means”” includes theft, bribery, misrepresentation, breach or inducement of a breach of a duty to maintain secrecy, to limit use, or to prohibit discovery of a trade secret, or espionage through electronic or other means.”<sup>200</sup>

In addition to injunctive relief for actual or threatened misappropriation, an injunction may condition future use of the trade secret upon the payment of a reasonable royalty to its owner.<sup>201</sup> A successful plaintiff may also recover damages for the actual loss caused by the misappropriation and the unjust enrichment that has not been taken into account in the actual loss calculation.<sup>202</sup> In lieu of damages measured by other means, the damages may be in the

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<sup>197</sup> § 134A.002(3)(A).

<sup>198</sup> § 134A.002(3).

<sup>199</sup> § 134A.002(3).

<sup>200</sup> Texas Uniform Trade Secrets Act § 134A.002(2).

<sup>201</sup> § 134A.003(a)–(b).

<sup>202</sup> § 134A.004(a).

form of liability for a reasonable royalty.<sup>203</sup> A finding of willful and malicious misappropriation allows damages of up to twice any award of actual loss caused by the misappropriation, unjust enrichment, or reasonable royalties under Subsection (a).<sup>204</sup> The prevailing party may be awarded reasonable attorneys' fees if the claim of misappropriation was made in bad faith, a motion to terminate an injunction is made or resisted in bad faith, or willful or malicious misappropriation is proven.<sup>205</sup>

Courts also enforce trade secret laws through criminal proceedings. Texas also allows for criminal penalties for theft of trade secret, which is considered a third-degree felony under Texas Penal Code Section 31.05(a)(4).

#### **6. Non-Uniform Language in the Texas UTSA**

There are a few differences between the language of the Texas UTSA and the uniform language of the UTSA. First, Texas UTSA's definition of "trade secret" includes "financial data" and a "list of actual or potential customers or suppliers," neither of which exist in the UTSA.<sup>206</sup> Also, there are two additional definitions. One is for "proper means," which is defined as "discovery by independent development, reverse engineering unless prohibited, or any other means that is not improper."<sup>207</sup> "Reverse engineering" is the other new definition in the Texas version. It means "the process of studying, analyzing, or disassembling a product or device to discover its design, structure, construction, or source code provided that the product or device was acquired lawfully or from a person having a legal right to convey it."<sup>208</sup> Finally, there is a presumption in favor of granting protective orders to preserve the secrecy of alleged trade secrets in litigation.<sup>209</sup>

#### **7. Economic Espionage Act of 1996 (EEA)**

The EEA is the federal act providing criminal penalties for misappropriating the trade secrets or competitive information of U.S. companies.<sup>210</sup> The EEA was enacted in October of 1996 to address the problem that there was no federal statute that prosecutors could use to prosecute economic espionage in a systematic manner other than the 1930's Interstate Transportation of Stolen Property Act, 18 U.S.C. § 2314.<sup>211</sup>

The Uniform Trade Secrets Act and other state statutes provided no effective criminal response.

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<sup>203</sup> § 134A.004(a).

<sup>204</sup> § 134A.004(b).

<sup>205</sup> § 134A.005.

<sup>206</sup> Texas Uniform Trade Secrets Act § 134A.002(6).

<sup>207</sup> § 134A.002(4).

<sup>208</sup> § 134A.002(5).

<sup>209</sup> § 134A.006.

<sup>210</sup> See 18 U.S.C. § 1831 (West 2012).

<sup>211</sup> Mark L. Krotzki, *Common Issues and Challenges in Prosecuting Trade Secret and Economic Espionage Act Cases*, ECON. ESPIONAGE AND TRADE SECRETS (Nov. 2009), [http://www.justice.gov/usao/eousa/foia\\_reading\\_room/usab5705.pdf](http://www.justice.gov/usao/eousa/foia_reading_room/usab5705.pdf).

The EEA contains two distinct provisions, § 1831, which addresses economic espionage directed by foreign governments, and § 1832, which prohibits the commercial theft of trade secrets carried out for economic or commercial advantage, whether the perpetrator is foreign or domestic.<sup>212</sup> Both sections may control acts committed outside the country.<sup>213</sup> The EEA applies if the offender is a citizen or resident alien of the United States, or an organization organized under the laws of the United States or any state.<sup>214</sup> Section 1831 applies when there is evidence of foreign government sponsored or coordinated intelligence activity.<sup>215</sup> The Government must prove that:

- (1) the defendant stole, or without the owner's authorization obtained, destroyed, or conveyed information that he knew or believed was a trade secret;
- (2) the information was a trade secret; and
- (3) the defendant intended or knew that the offense would benefit a foreign government, instrumentality, or agent.<sup>216</sup>

An individual convicted under § 1831 can be imprisoned for up to 15 years and be fined up to \$5,000,000 USD.<sup>217</sup> An organization can be fined the greater of \$10,000,000 USD or three times the value of the trade secret to the organization, including expenses for research and development and other costs of reproducing the trade secret that the theft avoided.<sup>218</sup>

Under § 1832, the Government must prove beyond a reasonable doubt that:

- (1) the defendant stole, or without the owner's authorization obtained, sent, destroyed, or conveyed information that he knew or believed was a trade secret;
- (2) the information was in fact a trade secret;
- (3) the defendant intended to convert the trade secret to the economic benefit of somebody other than the owner;
- (4) the defendant knew or intended that the owner of the trade secret would be injured; and
- (5) the trade secret was related to, or was included in, *a product or service used in or*

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<sup>212</sup> 18 U.S.C. §§ 1831, 1832.

<sup>213</sup> *See id.*

<sup>214</sup> 18 U.S.C. § 1837 (West 2012).

<sup>215</sup> *See* 18 U.S.C. § 1831.

<sup>216</sup> *United States v. Hanjuan Jin*, 833 F. Supp. 2d 977, 1005 (N.D. Ill. 2012).

<sup>217</sup> 18 U.S.C. § 1831(a).

<sup>218</sup> 18 U.S.C. § 1831(b).

*intended for use in* interstate or foreign commerce.<sup>219</sup>

An individual convicted under § 1832 can be imprisoned for up to ten years and fined of up to \$250,000 USD.<sup>220</sup> An organization can be fined up to \$5,000,000 USD.<sup>221</sup>

President Obama enacted the Theft of Trade Secrets Clarification Act of 2012 to clarify the scope of § 1832 to reverse *United States v. Aleynikov*.<sup>222</sup> It changed the prior language which required that the trade secret be “*included in a product that is produced for or placed in* interstate or foreign commerce . . .”<sup>223</sup> In that manner, the enactment of the Theft of Trade Secrets Clarification Act of 2012 provided for the protection of wholly internal proprietary information if the information relates to products or services that are used in interstate or foreign commerce. The case involved Aleynikov, a Goldman Sachs employee, who misappropriated internal information related to trading and was not found in violation of the statute’s former language.<sup>224</sup>

### III. CONCLUSION

Intellectual property rights is a complex topic, even when treated at a basic level. The interpretation of intellectual property law may be best left to specialists, but having knowledge of intellectual property basics may give the business lawyer the ability to react quickly to protect the important intellectual property of his or her client.

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<sup>219</sup> *Hanjuan Jin*, 833 F. Supp. 2d at 1005.

<sup>220</sup> 18 U.S.C. § 1832(a).

<sup>221</sup> 18 U.S.C. § 1832(b).

<sup>222</sup> See 18 U.S.C. § 1832.

<sup>223</sup> See Pub. L. No. 104-294, 110 Stat. 3489 (1996) (current version at 18 U.S.C. § 1832). The new language of Section 1832 is italicized in the corresponding text.

<sup>224</sup> Charles Doyle, *Stealing Trade Secrets and Economic Espionage: An Overview of 18 U.S.C. 1831 and 1832*, CONG. RESEARCH SERV. (Jan. 28, 2013), <https://www.fas.org/sgp/crs/secrecy/R42681.pdf>.



# THE TWISTED VEIL OF TEXAS LLCs

by Val Ricks\*

The Texas law of veil-piercing for limited liability companies is incoherent. It should be fixed. Section I tells what is wrong with the law. Section II proposes a fix.

## I. WHAT IS WRONG WITH THE TEXAS LAW OF LLC VEIL-PIERCING

### A. The Statute Prohibits Veil-Piercing.

Section 101.114 of the Texas Business Organizations Code (TBOC) contains a flat prohibition on imposing company liability on a member: “Except as and to the extent the company agreement specifically provides otherwise, a member or manager is not liable for a debt, obligation, or liability of a limited liability company . . .”<sup>1</sup> Because limited liability is usually a primary objective of LLC members, under normal circumstances a company agreement will not provide otherwise. It is difficult to imagine a clearer statement of non-liability. Its clarity led a prominent commentator to suggest that veil-piercing principles “should not apply to LLCs in Texas.”<sup>2</sup> Yet courts apply veil-piercing doctrine to LLCs.<sup>3</sup>

Commentators justify this as a common-law development.<sup>4</sup> But common law that disobeys

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\* Professor of Law, South Texas College of Law. The author wishes to thank John Bohannon for research assistance. The author also wishes to thank students in his Agency & Partnership classes for the last several years, who have diligently tried to learn the doctrine in this area notwithstanding its problems. Thank you for trying; our discussions clarified much.

<sup>1</sup> TEX. BUS. & ORG. CODE § 101.114 (West 2012).

<sup>2</sup> Byron F. Egan, *Choice of Entity Decision Tree After Margin Tax and Texas Business Organizations Code*, 42 TEX. J. BUS. L. 71, 173 (2007). In Egan’s defense, note that the uniform LLC act differs by allowing common law development. See Larry E. Ribstein & Robert R. Keatinge, *RIBSTEIN & KEATINGE ON LIMITED LIABILITY COMPANIES* §§ 12.1-12.2 (2011). The uniform act says only that members are not liable “solely by reason of being . . . a member.” *Id.* § 12.2. The Texas statute proclaims an absolute prohibition. See TEX. BUS. ORGS. CODE § 101.114 (West 2012).

<sup>3</sup> E.g., *Spring Street Partners-IV, L.P. v. Lam*, 730 F.3d 427, 445 (5th Cir. 2013); *In re Houst. Drywall, Inc.*, 2008 WL 2754526, \*32 (Bankr. S.D. Tex., July 10, 2008) (mem. op.) (holding that a limited partnership and its general partner, an LLC, were a “sham corporation” and unable to shield the individual controlling them from personal liability); *Bramante v. McClain*, 2007 WL 4555943 (W.D. Tex., Dec. 18, 2007) (mem. op.) (allowing a reverse veil piercing action to continue against an LLC and its owners); *DDH Aviation, L.L.C. v. Holly*, 2005 WL 770595, \*\*5-8 (N.D. Tex., Mar. 31, 2005) (mem. op.) (allowing an alter ego claim against a LLC); *In re Moore*, 379 B.R. 284, 284, 289 n.4 (Bankr. N.D. Tex. 2007) (“The court believes that whether a business enterprise is an LLC or a corporation is a distinction without a difference in this context.”); *In re JNS Aviation, LLC*, 376 B.R. 500, 525-31 (Bankr. N.D. Tex. 2007); *K-Solv, L.P. v. McDonald*, No. 01-11-00341-CV, 2013 WL 1928798, \*2 (Tex. App.—Houston [1st Dist.] May 9, 2013, no pet.) (mem. op.); *Shook v. Walden*, 368 S.W.3d 604 (Tex. App.—Austin 2012, pet. denied); *Penhollow Custom Homes, L.L.C. v. Kim*, 320 S.W.3d 366, 372-73 (Tex. App.—El Paso 2010, no pet.); *Phillips v. B.R. Brick and Masonry, Inc.*, No. 01-09-00311-CV, 2010 WL 3564820, \*7 (Tex. App.—Houston [1st Dist.] Sept. 10, 2010, no pet.) (mem. op.); *Sanchez v. Mulvaney*, 274 S.W.3d 708, 712 (Tex. App.—San Antonio 2008, no pet.); *McCarthy v. Wani Venture, A.S.*, 251 S.W.3d 573 (Tex. App.—Houston [1st Dist.] 2007, pet. denied); *Pinebrook Properties, Ltd. v. Brookhaven Lake Property Owners Ass’n*, 77 S.W.3d 487 (Tex. App.—Texarkana 2002, pet. denied) (dicta).

<sup>4</sup> See ELIZABETH S. MILLER & ROBERT A. RAGAZZO, 20 TEXAS PRACTICE SERIES: BUS. ORGS. § 20.7 (3d ed.

a statute is problematic. The legislature is supreme.<sup>5</sup> The commentators cite the corporate law of veil-piercing.<sup>6</sup> But the corporate code does not prohibit the imposition of corporate liability on shareholders. On the contrary, it explicitly provides for it.<sup>7</sup> Though section 21.223 limits shareholder liability, section 21.224 allows for the “liability of a holder . . . for an obligation that is limited by section 21.223.”<sup>8</sup> The explicit blessing of veil-piercing in the corporate code reaffirms its place in corporate law. The explicit condemnation of it in the LLC code appears to intend the opposite.

Notwithstanding section 101.114, there is space in our jurisprudence for LLC veil-piercing. In fact, no statute could stop it because it would not be an exercise in common law-making. Equity sometimes interferes with the application of statutes.<sup>9</sup> When a statute reaches an absurd result, a court is free to depart from it to an extent. I am not referring to the statutory construction rule that requires courts to avoid absurd interpretations.<sup>10</sup> Equity allows courts more leeway. Equity allows courts to depart from absurd statutes. The Texas Government Code itself recognizes the possibility in the following provision, complete with dangling modifier: “In enacting a statute, it is presumed that . . . a just and reasonable result is intended.”<sup>11</sup> When every construction of a statute is contrary to that presumption, what is a court to do? Many years ago, in *Witherspoon v. Jernigan*,<sup>12</sup> the Texas Supreme Court said,

The purpose of the Legislature . . . must be preserved even though it should require the court to disregard some of the words, or to supply words necessary to make plain the meaning of the law. When a literal interpretation of the language used would produce an absurdity, the court will restrict or enlarge the text so as to conform to the

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2011); Elizabeth S. Miller, *Are There Limits on Limited Liability? Owner Liability Protection and Piercing the Veil of Texas Business Entities*, 43 TEX. J. BUS. L. 417.

<sup>5</sup> *State v. City of Austin*, 331 S.W.2d 737, 743 (Tex. 1960) (“The judgment of the Legislature is supreme provided there is any reasonable basis for the action taken.”); *see also Gallagher Headquarters Ranch Dev., Ltd. v. City of San Antonio*, 269 S.W.3d 628, 638 (Tex. App.—San Antonio 2008, pet. granted) (“If we determine that the statute directly conflicts with the common law, the statute controls.”), *vacated on other grounds*, 303 S.W.3d 700 (Tex. 2010).

<sup>6</sup> *See, e.g.*, Miller & Ragazzo, *supra* note 4, at § 20.7 (“From a policy standpoint, there does not appear to be any reason for courts, when developing the Texas common law of LLC veil piercing, to adopt standards that explicitly provide less liability protection for an LLC member than that available to a corporate shareholder.”).

<sup>7</sup> *Id.*

<sup>8</sup> *See* TEX. BUS. ORG. CODE §§ 21.223-.224 (West 2012).

<sup>9</sup> I imagine a retort at this point: “In a jurisdiction in which law and equity are merged, development of equitable jurisdiction is common law-making.” No. There must be a distinction. Equity restricts itself in a manner the common law never has. If courts believe they have common law-making power in this area as they do in contracts or torts, then lawyers are doomed never to know the law, as the courts could simply pronounce it anew anytime they felt like creating legal authority contrary to a clear statute.

<sup>10</sup> *See Del Indus., Inc. v. Texas Workers’ Compensation Ins. Fund*, 973 S.W.2d 743, 747 (Tex. App.—Austin 1998) (“A court . . . will not construe a statute in a manner that will lead to a foolish or absurd result when another alternative is available.”) *aff’d* 35 S.W.3d 591 (Tex. 2000).

<sup>11</sup> TEX. GOV’T CODE § 311.021 (West 2012), made applicable to the TBOC by TEX. BUS. ORG. CODE § 1.051 (West 2013).

<sup>12</sup> 76 S.W. 445 (Tex. 1903).

general purposes and intent of the legislature.<sup>13</sup>

The *Witherspoon* court changed a statute to turn an “and” into an “or.”<sup>14</sup> Alternately, the court read into the statute a long phrase that implied the same substance.<sup>15</sup>

This jurisdiction in equity to prevent absurdity applies when following a statute would require the court to countenance a fraud. The equitable exception to the Statute of Frauds is a good example. In *Hooks v. Bridgewater*,<sup>16</sup> the court described when equity would allow a court to depart from a statutory mandate: “to prevent the perpetration of a fraud. That is the only ground that can justify its interference. Otherwise, the exercise of its jurisdiction for the practical annulment of the statute would be but bare usurpation.”<sup>17</sup>

Many cases confirm the equitable nature of the courts’ power to make an exception to a statute when following the statute would allow fraud to occur.<sup>18</sup> Pursuant to these equitable powers, Texas courts have enforced oral agreements covered by the Statute of Frauds, notwithstanding the Statute’s obvious applicability,<sup>19</sup> when equity dictated.<sup>20</sup> These are not broad exceptions. For instance, a sale of land does not have to be in writing if the consideration is paid, the vendee takes possession, and the vendee makes valuable and permanent improvements with the consent of the vendor.<sup>21</sup> But the elements are not the essential point. The *Hooks* court was quick to stress that the exception applied even without any improvements in “the presence of such facts as would make the transaction a fraud upon the purchaser if it were not enforced.”<sup>22</sup> The central claim for relief from the statute is that following the statute would permit or allow the perpetration of a fraud. In those cases, equity intervenes.

Equitable intervention is not limited to oral sales of land. Equity allows exception to the

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<sup>13</sup> *Id.* at 447.

<sup>14</sup> *Id.*

<sup>15</sup> *Id.*

<sup>16</sup> 229 S.W. 1114 (Tex. 1921).

<sup>17</sup> *Id.* at 1116.

<sup>18</sup> See, e.g., *Sharp v. Stacy*, 535 S.W.2d 345, 347-48 (Tex. 1976); *Cowden v. Bell*, 300 S.W.2d 286, 289-90 (Tex. 1957); *Texas Co. v. Burkett*, 296 S.W. 273, 279-80 (Tex. 1927); *Lovett v. Lovett*, 283 S.W.3d 391, 394 (Tex. App.—Waco 2008, pet. denied).

<sup>19</sup> The Statute of Frauds reads, “A promise or agreement described in Subsection (b) of this section is not enforceable unless the promise or agreement, or a memorandum of it, is (1) in writing; and (2) signed by the person to be charged with the promise or agreement or by someone lawfully authorized to sign for him.” TEX. BUS. & COM. CODE § 26.01(a) (West 2012).

<sup>20</sup> *Hooks v. Bridgewater*, 229 S.W. 1114, 1116 (Tex. 1921) (“Equity has no concern in such cases except to prevent the perpetration of a fraud.”); *Hunt v. Turner*, 9 Tex. 385, 385 (1853) (“A contract may be void under the statute of frauds; yet if the conduct of the party setting up the invalidity of the contract has been such as to raise an equity outside of and independent of the contract, and nothing else will be adequate satisfaction of such equity, it will sustain the sale, though not valid under the statute of frauds.”); *Dugan’s Heirs v. Colville’s Heirs*, 8 Tex. 126, 128 (Tex. 1852) (“such circumstances would raise an equity in favor of the vendee against his vendor, aside from and uncontrolled by the statute of frauds”); *Lovett v. Lovett*, 283 S.W.3d 391, 394 (Tex. App.—Waco 2008, pet. denied); *Carmack v. Beltway Development Co.*, 701 S.W.2d 37, 40 (Tex. App.—Dallas 1985, no writ) (“may be enforced in equity if denial of enforcement would amount to a virtual fraud”).

<sup>21</sup> *Hooks*, 229 S.W. at 1116.

<sup>22</sup> *Id.*; see also *Carmack*, 701 S.W.2d at 40.

Statute of Frauds also when a document meant to be a written lease for a period longer than a year has been prepared, the defendant promises to sign the document, and promissory estoppel applies to make that promise enforceable.<sup>23</sup> Here is a case in which the “enforcement of the statute of frauds ‘would, itself, plainly amount to a fraud.’”<sup>24</sup> Occasionally, Texas courts have named the excusing doctrine “estoppel”<sup>25</sup> or “promissory estoppel”<sup>26</sup> instead of fraud, though the equitable principle is similar. Texas courts have rendered such holdings with regard to oral employment contracts for longer than one year,<sup>27</sup> contracts to make mutual wills,<sup>28</sup> easements by estoppel,<sup>29</sup> and contracts for real estate commissions.<sup>30</sup> The general principle was aptly stated by a Texas appellate court: “The statute of frauds was designed to prevent fraud and may not be employed to bring about the very thing it was designed to prevent.”<sup>31</sup> Courts thus exercise their equitable power to depart from a statute when the application of the statute would be absurd. But this is a limited, extraordinary exception, not an exercise in common law-making. The courts are not free to make common law contrary to a constitutional statute.

A similar example is the equitable tolling of a statute of limitations. Most obviously, “the statute is tolled when by reason of fraud or concealment the defalcation or dereliction is kept hidden, until such time as knowledge is had of the defalcation, or in the exercise of reasonable diligence it might have become discovered.”<sup>32</sup> The statute is likewise tolled in various circumstances that are equivalent to fraud.<sup>33</sup> This occurs when the wrong party is initially sued but the proper defendant knew of the suit, was not prejudiced, and did nothing to notify the plaintiff, and in which the plaintiff was diligent.<sup>34</sup> Tolling on the basis of equitable estoppel is a similar move, technically contrary to the statute but necessary to prevent the statute from

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<sup>23</sup> *Southmark Corp. v. Life Investors, Inc.*, 851 F.2d 763, 768-69 (5th Cir. 1988) (applying Texas law); *Nagle v. Nagle*, 633 S.W.2d 796, 800 (Tex. 1982); *Moore Burger, Inc. v. Phillips Petroleum Co.*, 492 S.W.2d 934, 936-38, 940 (Tex. 1973).

<sup>24</sup> *Moore Burger*, 492 S.W.2d at 938.

<sup>25</sup> *Murphy v. Long*, 170 S.W.3d 621, 624-28 (Tex. App.—El Paso 2005, pet. denied).

<sup>26</sup> See, e.g., *Moore Burger*, 492 S.W.2d at 936-40.

<sup>27</sup> *Welch v. Coca-Cola Enterprises, Inc.*, 36 S.W.3d 532, 539 (Tex. App.—Tyler 2000, pet. dism'd by agr.).

<sup>28</sup> *Kilpatrick v. Estate of Harris*, 848 S.W.2d 859, 855 (Tex. App.—Corpus Christi 1993, no writ.) (reasoning that the promisor “must comply with the agreement, or equity will step in to prevent a fraud or to estop the survivor from pleading the statute of frauds”) (citing *Kastrin v. Janke*, 432 S.W.2d 539, 541 (Tex. Civ. App.—El Paso 1968, writ ref'd n.r.e.)).

<sup>29</sup> *Murphy v. Long*, 170 S.W.3d 621, 624-28 (Tex. App.—El Paso 2005, pet. denied); *N. Clear Lake Development Corp. v. Blackstock*, 450 S.W.2d 678 (Tex. Civ. App.—Houston 1970, writ ref'd n.r.e.).

<sup>30</sup> *Carmack*, 701 S.W.2d at 39-42.

<sup>31</sup> *Twelve Oaks Tower I, Ltd. v. Premier Allergy, Inc.*, 938 S.W.2d 102, 112 (Tex. App.—Houston [14<sup>th</sup> Dist.] 1996, no writ); see also *Morris v. Gaines*, 17 S.W. 538, 539 (Tex. 1891) (“The doctrine is well established that where either party, in reliance upon the verbal promise of the other, has been induced to do or to forbear to do any act, and thereby his position has been so changed for the worse that he would be defrauded by a failure to carry out the contract, equity will enforce a performance.”).

<sup>32</sup> *Franklin Cty. v. Tittle*, 189 S.W.2d 773, 774-75 (Tex. Civ. App.—Texarkana 1945, writ ref'd).

<sup>33</sup> See *Leonard v. Askew*, 731 S.W.2d 124, 128-29 (Tex. App.—Austin 1987, writ ref'd n.r.e.).

<sup>34</sup> E.g., *Continental Southern Lines, Inc. v. Hilland*, 528 S.W.2d 828 (Tex. 1975); *Torres v. Johnson*, 91 S.W.3d 905, 909-10 (Tex. App.—Fort Worth 2002, no pet.); *Palmer v. Enserch Corp.*, 728 S.W.2d 431 (Tex. App.—Austin 1987, writ ref'd n.r.e.).

countenancing fraud or what is in effect its equivalent.<sup>35</sup>

Unlike the corporate code, the LLC law prohibits veil-piercing, so courts are not free to amend in veil-piercing without establishing the equitable basis of the exception. I anticipate a counter-argument: “The corporate veil-piercing doctrine is itself based in equity. The corporation is a separate entity, so equitable jurisdiction was necessary.” No. It is possible to conceive corporate veil-piercing that way, and in the past, some of it may have arisen on that basis. But now there is no need for equitable jurisdiction because the corporate code directly allows veil-piercing. Section 21.223(b),<sup>36</sup> which allows veil-piercing for contractual debt when actual fraud is shown, preserves for contractual liability what equitable jurisdiction seems to demand, so even if the point would have been true, it is now moot. As the corporate statutes codify the courts’ equitable jurisdiction, the case law is not an assertion of it. Moreover, section 21.223<sup>37</sup> of the corporate code throttled corporate veil-piercing for contractual liability back to actual fraud, and all veil-piercing with respect to formalities, with nary a suggestion that the equitable jurisdiction of the courts was infringed. The lack of judicial assertion is proof there was no need.

But the courts’ lawlessness in the LLC veil-piercing area perhaps prompted the legislature in 2011 to address veil-piercing of LLCs. Unfortunately—

#### B. The LLC Code Was Amended in 2011 to Contradict Itself.

The “common law” that the courts applied to LLCs took its content from the statute that applied only to corporations.<sup>38</sup> The TBOC forbid this as well.<sup>39</sup> But if judges were going to act contrary to the prohibition in the LLC code, they could certainly borrow from corporate law contrary to the dictates of the corporate code. If the courts are not going to follow code, then they can depart from a little more code.

The legislature seemed to notice the issue and took it up in 2011. (How legislation resolves a conflict between the legislature and the courts is anyone’s guess. If the courts are not following statutes, passing another statute to stop them seems an ironic gesture.) In what looks at first glance like an attempt to cure the courts’ lawlessness, the legislature passed section 101.002 of the TBOC.<sup>40</sup> Section 101.002’s declarative provisions apply to limited liability companies the statutes that place limits on the veil-piercing of corporations.<sup>41</sup> The idea was to justify application of corporate statutes to LLCs—a sort of after-the-fact authorization of what the courts were already doing.

Oddly, though, the whole section 101.002 is made “[s]ubject to Section 101.114.” Section

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<sup>35</sup> See *Kamat v. Prakash*, 420 S.W.3d 890, 899-903 (Tex. App.—Houston [14<sup>th</sup> Dist.] 2014, no pet. h.).

<sup>36</sup> TEX. BUS. ORGS. CODE § 21.223 (West 2012).

<sup>37</sup> *Id.* § 21.223.

<sup>38</sup> Val Ricks, *Three Suggestions for the Texas Limited Liability Company Law*, 44 TEX. J. BUS. L. 29, 51-54 (2011); *see also* TEX. BUS. ORGS. CODE §§ 21.223-21.224 (West 2012).

<sup>39</sup> Ricks, *supra* note 38, at 51-54.

<sup>40</sup> TEX. BUS. ORGS. CODE § 101.002 (West 2012).

<sup>41</sup> *Id.* § 101.002.

101.114 is the LLC code provision stating flatly that “a member . . . is not liable for a debt, obligation, or liability of a limited liability company.” Put substantively, section 101.002 means that courts are to apply to limited liability companies the limitations on veil-piercing found in section 21.223 of the corporate code, subject to the more general notion that there will be no veil-piercing at all. What does it mean to say that the limits on veil-piercing that apply to corporations also apply to veil-piercing of limited liability companies, subject to a flat prohibition on any veil-piercing? While the substantive provisions of section 101.002 seem to suggest that veil-piercing will occur, and when it does it should be subject to the same limitations to which corporate veil-piercing is subject, the proviso to section 101.002 affirms a flat prohibition on the veil-piercing of LLCs. The statute contradicts itself.

Unfortunately, section 101.002’s suggestion that veil-piercing will occur also conflicts with another part of the LLC code—

### C. A Veil-Piercing Suit Against a LLC Member Is Procedurally Forbidden, by Statute.

The procedural posture of a veil-piercing case is also forbidden by the TBOC.<sup>42</sup> The statute, section 101.113, reads, “A member of a limited liability company may be named as a party in an action by or against the limited liability company only if the action is brought to enforce the member’s right against or liability to the company.”<sup>43</sup>

A veil-piercing suit is by definition brought to impose a LLC liability on a LLC member. Normally, veil-piercing suits name both the LLC and the member as defendants.<sup>44</sup> The plaintiff proves a cause of action against the LLC itself; this liability is then imposed on the member. However, section 101.113 forbids suing a LLC and its member in a single suit.<sup>45</sup> This rule prohibits the veil-piercing suit in its normal form. Other states whose statutes contain similar provisions<sup>46</sup> have so held.<sup>47</sup> The liability of a LLC can be established in one suit, but a

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<sup>42</sup> Ricks, *supra* note 38, at 58-60.

<sup>43</sup> TEX. BUS. ORGS. CODE § 101.113 (West 2012).

<sup>44</sup> See, e.g., Spring Street Partners-IV. L.P. v. Lam, 730 F.3d 427, 445 (5th Cir. 2013); Shook v. Walden, 368 S.W.3d 604 (Tex. App.—Austin 2012, pet. denied); Phillips v. B.R. Brick And Masonry, Inc., No. 01-09-00311-CV, 2010 WL 3564820 (Tex. App.— Houston [1st Dist.] Sept. 10, 2010, no pet.) (mem. op.); Sanchez v. Mulvaney, 274 S.W.3d 708, 712 (Tex. App.— San Antonio 2008, no pet.); McCarthy v. Wani Venture, A.S., 251 S.W.3d 573, 589 (Tex. App.— Houston [1st Dist.] 2007, pet. denied). This has also been true in the federal cases, where this procedural rule may or may not apply. See, e.g., *In re Hous. Drywall, Inc.*, No. 05-95161-H4-7, 2008 WL 2754526, \*32, (Bankr. S.D. Tex. July 10, 2008) (mem. op.); Bramante v. McClain, No. SA-06-CA-00102007, 2007 WL 4555943, \*6 (W.D. Tex. Dec. 18, 2007) (mem. op.); DDH Aviation, L.L.C. v. Holly, No. 3:02-CV-2598-P, 2005 WL 770595, \*5-8, (N.D. Tex. Mar. 31, 2005) (mem. op.); *In re Moore*, 379 B.R. 284, 284 *et seq.* & 289 n.4 (Bankr. N.D. Tex. 2007); *In re JNS Aviation, LLC*, 376 B.R. 500, 525-31 (Bankr. N.D. Tex. 2007).

<sup>45</sup> TEX. BUS. ORGS. CODE § 101.113 (West 2012) (“A member of a limited liability company may be named as a party in an action by or against the limited liability company only if the action is brought to enforce the member’s right against or liability to the company.”).

<sup>46</sup> Bishop and Kleinberger list five other states. Carter G. Bishop & Daniel S. Kleinberger, *Limited Liability Companies: Tax & Business Law* ¶ 6.01[3] n.48 (2014).

<sup>47</sup> See *Eastern Elec. Corp. of New Jersey v. Shoemaker Constr. Co.*, Order, No. 08-3825, 2009 WL 3397989 (E.D. Pa. Sept. 26, 2009) (applying Pennsylvania law); *In re Gillespie Opinion*, No. 2012 WL 102417, \*3 (W.D.N.C. Bankr., Mar. 26, 2012) (applying North Carolina law); *Dougle-Eight Oil and Gas, L.L.C. v. Caruthers Producing Co.*,

LLC member cannot be a party to that suit, so the lawsuit that establishes the LLC's liability cannot result directly in veil-piercing.

Can a second suit, brought after the LLC is successfully sued, be brought against a member? "An attempt to pierce the corporate veil, in and of itself, is not a cause of action but rather is a means of imposing liability on an underlying cause of action such as a tort or breach of contract."<sup>48</sup> Because veil-piercing is not a cause of action under Texas law, a second suit against the member for that liability is subject to summary judgment for no cause of action or failure to state a claim.<sup>49</sup> The limited liability company is, of course, an entity separate from its member, and a cause of action against a LLC is not a cause of action against a member. Moreover, section 101.114, which forbids the imposition of any kind of limited liability company liability on a member, appears to have anticipated a "second suit" approach: it forbids imposing LLC liability on a member for "a debt, obligation, or liability under a judgment, decree, or order of a court."<sup>50</sup> A second suit based on liability established against a LLC in a first suit would be "a debt, obligation, or liability under a judgment, decree, or order of a court," the very thing section 101.114 forbids.<sup>51</sup>

Perhaps section 101.113's purpose is narrower than prohibiting veil-piercing suits? Discerning such an other purpose is difficult at best. Miller and Ragazzo claim the section "reflects the principle that an LLC is an entity separate from its members."<sup>52</sup> Obviously it does so, but that much is explicit in the code's very definition of *limited liability company* ("means an entity").<sup>53</sup> Surely section 101.113 did not mean merely to restate this obvious point. That a person and an entity are separate does not mean they cannot be "named as a party in an action . . . against" the other. Section 101.113 goes well beyond parroting the separateness of LLCs and members.

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13 So.3d 754, 757-58 (La. Ct. App. 2009); *Page v. Roscoe, LLC*, 497 S.E.2d 422, 428 (N.C. App. 1998) (imposing Rule 11 sanctions for including the member as a party defendant); *see also, e.g.*, *Primary Investments, LLC v. Wee Tender Care III, Inc.*, 746 S.E.2d 823, 827-28 (Ga. Ct. App. 2013). The statute has also been used to forbid standing of a member to sue for an obligation to the LLC. *Crozier v. Gattoni*, 28 Conn. L. Rptr. 320 (Conn. Superior Ct. 2000).

<sup>48</sup> *Gallagher v. McClure Bintliff*, 740 S.W.2d 118, 119-20 (Tex. App.—Austin 1987, writ denied); *see, e.g.*, *Spring Street Partners-IV, L.P. v. Lam*, 730 F.3d 427, 443 (5th Cir. 2013) (applying Texas law); *Phillips v. United Heritage Corp.*, 319 S.W.3d 156, 158 (Tex. App.—Waco 2010, no pet.) ("[T]hese theories and the attempts to utilize them are not substantive causes of action."); *Wilson v. Davis*, 305 S.W.3d 57, 68 (Tex. App.—Houston [1st Dist.] 2009, no pet.); *Cox v. S. Garrett, L.L.C.*, 245 S.W.3d 574, 582 (Tex. App.—Houston [1st Dist.] 2007, no pet.); *Specialty Retailers, Inc. v. Fuqua*, 29 S.W.3d 140, 147 (Tex. App.—Houston [14th Dist.] 2000, pet. denied); *Farr v. Sun World Sav. Ass'n*, 810 S.W.2d 294, 297 (Tex. App.—El Paso 1991, no writ); *Gulf Reduction Corp. v. Boyles Galvanizing & Plating Co.*, 456 S.W.2d 476, 479 (Tex. Civ. App.—Fort Worth 1970, no writ). Unpublished authority also exists. *See Rio Grande H2O Guardian v. Robert Juller Family Partnership Ltd.*, No. 04-13-00441, 2014 WL 309776, \*4 (Tex. App.—San Antonio 2014, no pet.).

<sup>49</sup> *See MT Falkin Investments, L.L.C. v. Chisholm Trail Elks Lodge No. 2659*, 400 S.W.3d 658 (Tex. App.—Austin 2013, pet. denied) (granting summary judgment to an association member named as a defendant because the association was a separate legal entity); *Sewell v. Smith*, 819 S.W.2d 565 (Tex. App.—Dallas 1991, no writ) *aff'd* 858 S.W.2d 350 (Tex. 1993); *Weibel v. Martin Indus., Inc.*, 806 S.W.2d 345 (Tex. App.—Fort Worth 1991, writ denied).

<sup>50</sup> TEX. BUS. ORGS. CODE § 101.114 (West 2012).

<sup>51</sup> *See Dougle-Eight Oil and Gas, L.L.C. v. Caruthers Producing Co.*, 13 So.3d 754, 757-58 (La. Ct. App. 2009).

<sup>52</sup> Miller & Ragazzo, *supra* note 4, at § 20.45; *accord* Bishop & Kleinberger, *supra* note 46, ¶ 6.01[3].

<sup>53</sup> TEX. BUS. ORGS. CODE ANN. § 1.002(46) (West 2012).

The statute's purpose is more obviously shown by its location. Its placement next to section 101.114 suggests its relevance to veil-piercing and is a holdover from the prior limited liability company code, where the two provisions were together in the same article.<sup>54</sup> The procedural provision is most reasonably read as an additional protection against the imposition of entity liability on company members.

Section 101.113 has no corporate analog. In Texas law, it is unique to the LLC. It is thus an impediment to veil-piercing that is shared by no other entity.

Evidence in the case law suggests that, until very lately, both courts and lawyers have ignored section 101.113.<sup>55</sup> When the statute was finally raised before a court in May 2013, the plaintiff bringing the veil-piercing suit audaciously suggested that, as the statute had been ignored previously, it could be ignored now!<sup>56</sup> The case law allowing suits forbidden by the code is part of the incoherence of the law's current approach to LLC veil-piercing.

#### **D. Incorporation of the Corporate Statute, Itself Muddled, Is Not Such a Great Idea.**

When courts decided to apply veil-piercing principles to LLCs, they adopted the same principles applicable to corporations. At least part of section 101.002 now appears to authorize the use of those principles to LLCs. Is that such a good idea? I have discussed some objections to these doctrines before in greater detail<sup>57</sup> and will recapitulate here.

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<sup>54</sup> In the prior instantiation of the limited liability company code, the provision was grouped with the predecessor to section 101.114 in article 4.03. TEXAS LIMITED LIABILITY COMPANY ACT art. 4.03 (expired Jan. 1, 2010). The predecessor statute was followed in *Video Ocean Group LLC v. Balaji Management, Inc.*, 2006 WL 964565, \*11 (S.D. Tex. Apr. 12, 2006) (mem. op.), to prohibit a LLC member from suing as a co-plaintiff with the LCC which the member owned.

<sup>55</sup> The statute is cited only a few times in Texas case law, once by a court that appears to have ignored it completely, *Shook v. Walden*, 368 S.W.3d 604, 613 (Tex. App.—Austin 2012, pet. denied), and thrice by courts who sidestepped the issue to affirm a judgment for LLC members on another ground, *Fin & Feather Club v. Leander*, 415 S.W.3d 548, 556 (Tex. App.—Dallas 2013, no pet.); *Metroplex Mailing Services, LLC v. RR Donnelley & Sons Co.*, 410 S.W.3d 889, 897-98 (Tex. App.—Dallas 2013, no pet.); *K-Solv, L.P. v. McDonald*, No. 01-11-00341-CV, 2013 WL 1928798 (Tex. App.—Houston [1st Dist.] May 9, 2013, no pet.) (mem. op.). *See also* note 54, *supra*. All other courts granting veil-piercing relief to plaintiffs in LLC veil-piercing cases appear to have been ignorant of the statute; surely the LLC-member defendants failed to argue it. Interestingly, the argument against section 101.113 in *K-Solv* was that “despite these statutory provisions, Texas courts have nevertheless applied common-law veil-piercing theories in the LLC context.” *K-Solv*, 2013 WL 1928798 at \*2. In other words, if everyone else ignores the legislature, what’s the harm? The statute was referred to as supportive reasoning on facts that did not require its application, in *Barrera v. Cherer*, No. 04-13-00612-CV, 2014 WL 1713522, \*2 (Tex. App.—San Antonio Apr. 30, 2014, no pet.) (mem. op.). Of course, the courts have allowed numerous suits to continue against both a LLC and its member notwithstanding the statute, and without ever mentioning it. *See* cases cited footnote 44.

<sup>56</sup> The *K-Solv, LP* decision was the first to ask in print whether section 101.113 had any effect. *See* No. 01-11-00341-CV, 2013 WL 1928798, \*2 (Tex. App.—Houston [1st Dist.] May 9, 2013, no pet.) (mem. op.). The argument against section 101.113 in *K-Solv* was that “despite these statutory provisions, Texas courts have nevertheless applied common-law veil-piercing theories in the LLC context.” *Id.* at \*2. Restated, this argument is merely that courts have acted inconsistently with the law before and therefore can again.

<sup>57</sup> *See* Ricks, *supra* note 38, at 54-58.

### 1. *Actual Fraud*

The most glaring incoherence in the statute limiting veil-piercing of corporations is the use of the phrase “actual fraud” to describe both a limit on veil-piercing for contractual liability and an exception to that limit. The corporate statute now perhaps applicable to LLCs reads as follows:

(a) A holder of shares . . . may not be held liable to the corporation or its obligees with respect to: . . . (2) any contractual obligation of the corporation . . . on the basis of actual or constructive fraud . . .<sup>58</sup>

This limitation is itself limited in the same statute:

(b) Subsection (a)(2) does not prevent or limit the liability of a holder . . . if the obligee demonstrates that the holder . . . caused the corporation to be used for the purpose of perpetrating and did perpetrate an actual fraud on the obligee primarily for the direct personal benefit of the holder . . .<sup>59</sup>

The use of “actual fraud” this way, in this statute, creates incoherence for a number of reasons, even besides the obvious circularity.

First, “actual fraud” has several potential meanings in the law. The most obvious meaning—the tort of actual fraud (as opposed to constructive fraud)—does not fit here at all.<sup>60</sup> That cannot logically be the meaning of the statute. If a person commits the tort of fraud, then that person is individually liable for resulting damages.<sup>61</sup> No veil-piercing is necessary to hold such a person liable; that person is liable independently of any corporate liability.<sup>62</sup>

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<sup>58</sup> TEX. BUS. ORGS. CODE § 21.223(a)(2) (West 2012).

<sup>59</sup> *Id.* § 21.223(b).

<sup>60</sup> See *In re Ritz*, 513 B.R. 510, 538 (S.D. Tex. 2014); *Latham v. Burgher*, 320 S.W.3d 602, 607 (Tex. App.—Dallas 2010); e.g., *Spring Street Partners-IV, L.P. v. Lam*, 730 F.3d 427 (5<sup>th</sup> Cir. 2013) (finding actual fraud for purpose of veil-piercing on facts lacking a misrepresentation); *Tryco Enterprises, Inc. v. Robinson*, 390 S.W.3d 508, 510 (Tex. App.—Houston [1<sup>st</sup> Dist.] 2012, pet. dism’d) (same).

<sup>61</sup> *Ricks, supra* note 38, at 55; see *Baylor Univ. v. Sonnichsen*, 221 S.W.3d 632, 636 (Tex. 2007); *Formosa Plastics Corp. USA v. Presidio Eng’rs & Contractors, Inc.*, 960 S.W.2d 41, 49 (Tex. 1998); *Arthur Andersen & Co. v. Perry Equip. Corp.*, 945 S.W.2d 812, 817 (Tex. 1997). The defendant LLC member in *McCarthy v. Wani Venture, A.S.*, 251 S.W.3d 573 (Tex. App.—Houston [1<sup>st</sup> Dist.] 2007, pet. denied), was probably liable for the tort of fraud. Compare *McCarthy*’s jury instruction elements for fraud (taken from the Texas pattern jury charge), 251 S.W.3d at 584, with the elements of fraud set forth in *Aquaplex, Inc. v. Rancho La Valencia, Inc.*, 297 S.W.3d 768, 774 (Tex. 2009). In *McCarthy*, a finding of veil-piercing was probably unnecessary.

<sup>62</sup> See, e.g., *Weitzel v. Barnes*, 691 S.W.2d 598, 601 (Tex. 1985) (affirming individual liability for DTPA violations perpetrated while serving as agents of a corporation); *Nwokedi v. Unlimited Restoration Specialists, Inc.*, 428 S.W.3d 191, 201 n.1 (Tex. App.—Houston [1<sup>st</sup> Dist.] 2014, pet. denied) (affirming a controlling shareholder’s individual liability for fraud, without veil-piercing); *Walker v. Anderson*, 232 S.W.3d 899, 918-20 (Tex. App.—Dallas 2007, no pet.) (affirming a corporate shareholder’s individual liability for fraud, without veil-piercing, and stating, “[A] corporate officer who knowingly participates in tortious or fraudulent acts may be held individually liable to third persons even though he performed the act as an agent of the corporation.”); *Kingston v. Helm*, 82 S.W.3d 755, 758-59 (Tex. App.—Corpus Christi 2002, pet. denied).

Consequently, the abolition of an actual fraud veil-piercing theory in (a)(2) of the statute had no effect on the common law tort of fraud. If (a)(2) and (b) referred to the tort of fraud, subsection (b) would be completely unnecessary as an exception to (a)(2).

The next most obvious meaning, and the one I believe was probably intended by the statute, is at best ambiguous. The Texas Supreme Court case that the corporate statute meant to correct, *Castleberry v. Branscum*,<sup>63</sup> employed the phrase “actual fraud” to describe a ground for veil-piercing liability.<sup>64</sup> I have omitted theories other than “actual fraud” from the quoted statute above, but subsection (a)(2) of the statute named several others that the *Castleberry* court also listed.<sup>65</sup> Because “actual fraud” comes from *Castleberry*, one should turn to *Castleberry* for its meaning. On this, the case provides some limited guidance:

To prove there has been a sham to perpetrate a fraud, tort claimants and contract creditors must show only constructive fraud. We distinguished constructive from actual fraud in *Archer v. Griffith*:

Actual fraud usually involves dishonesty of purpose or intent to deceive, whereas constructive fraud is the breach of some legal or equitable duty which, irrespective of moral guilt, the law declares fraudulent because of its tendency to deceive others, to violate confidence, or to injure public interests.<sup>66</sup>

Logically, then, the statute’s reference to actual fraud means some action done with “dishonesty of purpose or intent to deceive.” The problem with that definition is that it refers only to intent. A mental state is not something one can perpetrate, as subsection (b) seems to require: “caused the corporation to be used for the purpose of perpetrating and did perpetrate an actual fraud.”<sup>67</sup>

I do not doubt that the law can construct a meaning around the phrase “actual fraud,” and case law is finally now defining it (usually to mean what it meant in *Castleberry*, despite the difficulty).<sup>68</sup> But the statute in its present form does not dictate to the courts, because the

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<sup>63</sup> 721 S.W.2d 270 (Tex. 1986).

<sup>64</sup> *Id.* at 273. Brent Lee cites this as a reason for presuming the legislature intended *Castleberry*’s meaning. Brent Lee, *Veil Piercing and Actual Fraud Under Article 2.21 of the Texas Business Corporation Act*, 54 BAYLOR L. REV. 427, 438-39 (2002).

<sup>65</sup> Compare TEX. BUS. ORGS. CODE § 21.223(a)(2) (West 2012) (“alter ego . . . [,] actual or constructive fraud, a sham to perpetrate a fraud, or other similar theory”), with *Castleberry*, 721 S.W.2d at 271-73 (listing alter ego, actual fraud, constructive fraud, and sham to perpetrate a fraud as viable theories).

<sup>66</sup> *Castleberry*, 721 S.W.2d at 273, (quoting *Archer v. Griffith*, 390 S.W.2d 735, 740 (Tex. 1964)).

<sup>67</sup> TEX. BUS. ORGS. CODE § 21.223(b) (West 2012).

<sup>68</sup> Spring Street Partners-IV, L.P. v. Lam, 730 F.3d 427, 442-43 (5th Cir. 2013); *In re Ritz*, 513 B.R. 510, 536 (S.D. Tex. 2014) (“Within the meaning of the Business Organizations Code for piercing the corporate veil regarding a contractual obligation, ‘actual fraud’ . . . ‘involves dishonesty of purpose or intent to deceive.’”); *Ogbonna v. USPLabs, LLC*, 2014 WL 2592097, \*8-12 (W.D. Tex., June 10, 2014) (“Actual fraud, in this context, involves dishonesty of purpose or intent to deceive, and is not equivalent to the tort of fraud.”); *Maxwell v. Neri North America*, No. 4:13-cv-269, 2014 WL 2441200 \*\* 4-5 (S.D. Tex., May 30, 2014) (mem. op.); *Weston Group, Inc. v.*

statute has no clear meaning.

## 2. ***“Other Theories”***

This is not the only ambiguity in the corporate statute. The statute as noted does not list all of the theories of veil-piercing that it disallows for contractual liability; it instead gives examples and tags on “or other similar theory.”<sup>69</sup> The result is that the similarity of every other theory must be litigated to the Texas Supreme Court to see if it is “similar.” This has happened over and over again in the courts of appeal until the Texas Supreme Court finally took up each theory and settled the matter.<sup>70</sup> That ambiguity is now spread to LLCs, where it may or may not generate more litigation.

## 3. ***Formalities***

The corporate statute also limits the use of a “formality” in veil piercing:

A holder of shares . . . may not be held liable to the corporation or its obligees with respect to . . . (3) any obligation of the corporation on the basis of the failure of the corporation to observe any corporate formality, including the failure to: (A) comply with this code or the certificate of formation or bylaws of the corporation; or (B) observe any requirement prescribed by this code or the certificate of formation or bylaws of the corporation for acts to be taken by the corporation or its directors or shareholders.<sup>71</sup>

On the one hand, the point of this clause seems clear: a shareholder should not be liable because, for example, the board of directors did not meet, or not every accounting rule was followed. Commentators have pointed out the irrelevance of certain formal, corporate acts to

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Sw. Home Health Care, LP, No. 3:12-CV-1964-G, 2014 WL 940329, \* 4-5 (N.D. Tex., Mar. 11, 2014) (mem. op.); *In re Arnette*, 454 B.R. 663, 694-95 (Bankr. N.D. Tex. 2011) (“In the context of piercing the corporate veil, the concept of ‘actual fraud’ contained in section 21.223 is not the same as the common law tort of fraud . . . .”); *Weaver & Tidwell, L.L.P. v. Guarantee Co. of North America USA*, 427 S.W.3d 559, 574 (Tex. App.—Dallas 2014, no pet. h.); *Fin & Feather Club v. Leander*, 415 S.W.3d 548, 556 (Tex. App.—Texarkana 2013, no pet.); *Metroplex Mailing Servs., LLC v. RR Donnelley & Sons Co.*, 410 S.W.3d 889, 896 (Tex. App.—Dallas 2013, no pet.); *Tryco Enters., Inc. v. Robinson*, 390 S.W.3d 497, 508 (Tex. App.—Houston [1st Dist.] 2012, no pet.); *Shook v. Walden*, 368 S.W.3d 604, 621 (Tex. App.—Austin 2012, pet. denied); *Latham v. Burgher*, 320 S.W.3d 602, 606 (Tex. App.—Dallas 2010, no pet.) (“[I]n the context of piercing the corporate veil, actual fraud is not equivalent to the tort of fraud. Instead, in that context, actual fraud involves ‘dishonesty of purpose or intent to deceive.’”); *see Dick’s Last Resort of West End, Inc. v. Market/Ross, Ltd.*, 273 S.W.3d 905, 908-09 (Tex. App.—Dallas 2008, no pet.); *Solutioneers Consulting, Ltd. v. Gulf Greyhound Partners, Ltd.*, 237 S.W.3d 379, 387-89 (Tex. App.—Houston [14th Dist.] 2007, no pet.); *Menetti v. Chavers*, 974 S.W.2d 168, 174 (Tex. App.—San Antonio 1998, no pet.).

<sup>69</sup> TEX. BUS. ORGS. CODE § 21.223(a)(2) (West 2012).

<sup>70</sup> *See, e.g.*, *Willis v. Donnelly*, 199 S.W.3d 262, 273 (Tex. 2006) (settling the ratification theory); *S. Union Co. v. City of Edinburg*, 129 S.W.3d 74, 85-90 (Tex. 2003) (settling the enterprise theory). While the cases were percolating in the courts of appeals, commentators felt obliged to tell the courts how to interpret the ambiguous passage. *See* the long list of commentary cited at Ricks, *supra* note 38, at 57 n.177.

<sup>71</sup> TEX. BUS. ORGS. CODE § 21.223(a)(3) (West 2012).

shareholder liability.<sup>72</sup> As a relevance criterion, this qualification is unobjectionable. However, the statute does not phrase the limitation as a relevance criterion, and until a court clarifies it as such, we are likely to see litigation over a host of practices that one party sees as formalism and the other sees as substantive. After all, whether an act is a formalism or substance depends on its and the actor's purpose.<sup>73</sup> The ultimate formalism in the code is the filing of the certificate of formation,<sup>74</sup> yet corporate existence under the law depends on this paper being filed.<sup>75</sup> To the creditor who thought it had obtained a resolution from a board<sup>76</sup> authorizing the transaction that created the debt, the lack of a meeting<sup>77</sup> might be the very basis of a fraud—even an “actual fraud.” To a creditor looking for funds that have been commingled, the lack of accounting allows the controlling shareholder to commit fraud. The difficulty in determining what is a formality is perhaps one reason formalities seem to come up in courts’ analyses of veil-piercing cases notwithstanding the statute.<sup>78</sup> This statute simply does not say yet what it needs to say; it does not contain its animating principle within its terms.

Moreover, operators of Texas entities who follow the suggestion of the statute may be fooled into believing “formalities”—often requirements of the code or the certificate of formation—are not important. Following the law is always important, however; general prudence suggests counsel should diligently advise that “formalities” be observed. In fact, Texas entities—and shareholders and LLC members—may have to answer for them notwithstanding the TBOC’s provision. Under choice of law rules that govern in courts outside the state, the law of the forum state rather than the state of incorporation may govern the veil-piercing issue.<sup>79</sup> Moreover, in federal question cases, federal choice of law principles may

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<sup>72</sup> See, e.g., Franklin A. Gevurtz, *CORPORATION LAW* § 1.5.4 (2d ed. 2010); *TFH Properties, LLC v. MCM Development, LLC*, Order, No. CV-09-8050-PCT-FJM, 2010 WL 2720843, \*6-7 (D. Ariz., July 9, 2010) (interpreting Utah’s prohibition on the use of formalities in LLC veil-piercing analysis in the following manner: evidence of failure to observe formalities is allowed to show alter ego but could not be the sole basis for veil piercing). The *TFH Properties* analysis makes good sense; it limits failure to abide by formalities to where it is relevant.

<sup>73</sup> This is why a recent majority opinion could cite in support of veil-piercing that the shareholders “neglected the corporate formality of paying [the corporation’s] franchise tax” (an event which is grounds for administrative termination of the corporation by the state, *see TEX. BUS. ORGS. CODE* § 11.251 (West 2012)) only to have the dissent criticize that for relying on a formality. *Cf. Tryco Enterprises, Inc. v. Robinson*, 390 S.W.3d 497, 509 (Tex. App.—Houston 1<sup>st</sup> Dist.] 2012, pet. dism’d), *with id.* at 525 (Massengale, J., dissenting); *cf. also* Gevurtz, *supra* note 72.

<sup>74</sup> Unbelievably, this is the so-called “formality” at issue in *Scott v. McKay*, No. 12-02-00195-CV, 2003 WL 21998629, \*3 (Tex. App.—Tyler Aug. 20, 2003, no pet.) (mem. op.).

<sup>75</sup> *TEX. BUS. ORGS. CODE* § 3.001(c) (West 2012) (“the existence of a filing entity commences when the filing of the certificate takes effect”). It is possible for a corporation to form *de facto* without a filing, but this requires proof in court of evidence sufficient to show *de facto* formation. *See, e.g., TEX. BUS. ORGS. CODE* § 3.001(d); Val D. Ricks, *The Revival of De Facto Incorporation in Texas*, 25 CORP. COUNSEL REV. 77 (2006).

<sup>76</sup> Failure to obtain a resolution was deemed a “corporate formalit[y]” that the court then discussed as if it were relevant, notwithstanding its citation to the statute, in *Schlueter v. Carey*, 112 S.W.3d 164 (Tex. App.—Fort Worth 2003, pet. denied).

<sup>77</sup> This is the corporate formality deemed unusable in *Morris v. Powell*, 150 S.W.3d 212, 220 (Tex. App.—San Antonio 2004, no pet.). That the corporation held meetings at a certain office was the fact employed in the court’s analysis in *Dominguez v. Payne*, 112 S.W.3d 866, 870 (Tex. App.—Edinburg 2003, no pet.).

<sup>78</sup> E.g., *Wilson v. Davis*, 305 S.W.3d 57, 71 (Tex. App.—Houston [1st Dist.] 2009, no pet.); *Schlueter v. Carey*, 112 S.W.3d 164 (Tex. App.—Fort Worth 2003, pet. denied).

<sup>79</sup> E.g., *B&H Nat. Place, Inc. v. Beresford*, 850 F. Supp. 2d 251, 259-60 & n.14 (D.D.C. 2012) (applying D.C.

dictate that the federal common law of veil-piercing applies,<sup>80</sup> and the federal law may take account of formalities that Texas law does not.<sup>81</sup> So it is possible for the owners of a Texas entity to find themselves liable under the veil-piercing law of another jurisdiction, where formalities matter.<sup>82</sup>

Even more concerning is the application of the “formalities are not considered” principle to the LLC. The likelihood of an unjust or illogical application of that principle is magnified in the LLC context, where the code requires little in the way of formalities. The LLC—“its relations among members, managers, . . . and the company itself,” as well as its “other internal affairs”—is governed by agreement.<sup>83</sup> Unlike the corporate code, which as a default requires a board of directors and officers,<sup>84</sup> meetings of board and shareholders,<sup>85</sup> notices of meetings,<sup>86</sup> and the like,<sup>87</sup> the LLC code by default allows members to manage,<sup>88</sup> requires no meeting of members, and in general eschews formality in favor of consent.<sup>89</sup> In this very different

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law to a veil-piercing issue of a corporation formed in Virginia); TAC-Critical Systems, Inc. v. Integrated Facility Systems, Inc., 808 F.Supp. 2d 60, 63-65 (D.D.C. 2011) (same); Harrelson v. Seung Heun Lee, 798 F. Supp. 2d 310, 316 n.4 (D. Mass. 2011) (applying Massachusetts law in the veil-piercing of Arizona corporations); *In re Botten*, 54 B.R. 707, 708-09 (Bankr. W.D. Wis. 1985) (applying Wisconsin law to an apparently non-Wisconsin corporation's veil-piercing because “the rights of third parties are affected”); Multi-Media Holdings, Inc. v. Piedmont Center, 15 LLC, 583 S.E.2d 262 (Ga. App. 2003) (applying Georgia law to the veil-piercing of a Delaware corporation); Cahaly v. Benistar Property Exchange Trust Co., Inc., 864 N.E.2d 548, 558 n.16 (Mass. App. Ct. 2007); UBS Secs. LLC v. Highland Capital Mgmt., L.P., 924 N.Y.S.2d 312 (N.Y. Sup. 2011) (applying N.Y. Law to a Cayman Islands corporation veil-piercing issue); *see also, e.g.*, U.S. v. Clinical Leasing Service, Inc. 982 F.2d 900, 902 (5th Cir. 1992) (applying Louisiana law to a Delaware corporation's veil-piercing because the parties agreed but also citing in justification Restatement (Second) Conflicts of Laws § 306 (1971) (“some other state has a more significant relationship”)); Channing v. Equifax, Inc., 2013 WL 593942, \*3 & n.1 (E.D.N.C., Feb. 15, 2013); Hitachi Medical Systems America, Inc. v. Branch, 2010 WL 816344, \*8 (N.D. Ohio, Mar. 4, 2010) (mem. op.) (reserving the issue and ordering further briefing because the choice of law issue could determine the outcome). The majority of course apply the internal affairs doctrine to veil-piercing issues.

<sup>80</sup> *E.g.*, Brotherhood of Locomotive Eng'rs v. Springfield Term. Ry. Co., 210 F.3d 18, 25-33 (1st Cir. 2000) (applying federal common law of veil-piercing), *cert. denied*, 531 U.S. 1014 (2000).

<sup>81</sup> *See* Alvarez v. 9ER'S Grill@Blackhawk, L.L.C., Civ. A. H-08-2905, 2009 WL 2252243 (S.D. Tex. 2009) (mem. op.). *Alvarez* applied federal single business enterprise theory under the Federal Labor Standards Act to two Texas LLCs engaged in the restaurant business. *Id.* In concluding that the two should be treated as one, the court cited that the two LLCs were organized when a single organizer filed articles of organization for both. *Id.* at \*6.

<sup>82</sup> *See* Brotherhood of Locomotive Eng'rs, 210 F.3d at 29 (“Other factors may also be relevant, such as whether the carrier and the related corporation fail to observe separate corporate formalities, or whether the related corporation is undercapitalized.”).

<sup>83</sup> TEX. BUS. ORGS. CODE § 101.052(a) (West 2012).

<sup>84</sup> *Id.* §§ 21.401, 21.417.

<sup>85</sup> *Id.* §§ 21.351, 21.409(a), 21.415.

<sup>86</sup> *Id.* §§ 21.353, 21.411(b).

<sup>87</sup> *Id.* §§ 21.302 (board authorization of distributions), 21.367 (proxy voting), 21.372 (shareholder voting list), 21.456 (voting required for fundamental business transactions).

<sup>88</sup> *Id.* § 3.010.

<sup>89</sup> While the code appears to require a governing authority of members to meet, *id.* §§ 101.355-356, managing members may vote by proxy, *id.* § 101.357(a)(2), and by default action can also be taken with less than unanimous consent, without a meeting, *id.* § 101.358. This contrasts with the corporation, whose directors must deliberate and vote in person and where voting by consent with less than unanimity requires permission of the shareholders in writing in advance.

context, what counts as a formality and what as substance is even more likely to be confused, and the corporate precedents should not control.<sup>90</sup>

In fact, several states' LLC codes provide that failure to observe formalities "is not a ground for imposing personal liability on the members . . . for liabilities of the company."<sup>91</sup> Jurisprudence under these statutes, from other jurisdictions, may be more relevant where LLCs are involved than Texas' own experience under its corporate code, despite the source of Texas' prohibition on the analysis of LLC formalities.

#### 4. *Reverse Veil-Piercing*

Finally, the corporate statute is inapplicable to reverse piercing claims,<sup>92</sup> and the LLC code's adoption of the corporate statute does not remedy this omission.<sup>93</sup> In a reverse veil-piercing, a corporation is held liable for a shareholder's liability.<sup>94</sup> Reverse piercing can happen to LLCs, too.<sup>95</sup> If the unity of the corporation and the shareholder combined with the commission of some inequitable conduct or constructive fraud is not sufficient to pierce the veil against a LLC member for contractual liability, why should it be sufficient when a creditor of the member seeks to hold the LLC liable for the member's contract debt? And if formalities should not be considered for veil-piercing, why should they be considered for reverse veil-piercing? Courts should tread even more lightly in that circumstance because other creditors with claims against the LLC or the member may exist.<sup>96</sup> Yet in the case of reverse veil-piercing, the statutory limitation, merely an exception to a prohibition on shareholder liability, by its own terms does not apply.

## II. A PROPOSAL FOR FIXING THE STATUTE

Notwithstanding the endless fun I have describing this thicket to my students, they do not enjoy walking through it. We cannot understand the law, and predicting its application is impossible. The best we can discern is a set of arguments: Argue against veil-piercing based on section 101.114 and its reiteration in 101.002. Argue that your LLC-member client cannot be a defendant under 101.113. Argue that if the LLC has already been held liable in a prior suit that the LLC's liability cannot be imposed on the member, under the second half of 101.114. These

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<sup>90</sup> *Accord* Ribstein & Keatinge, *supra* note 2, § 12.3; Robert R. Keatinge, *et al.* *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 375, 445-46 (1992).

<sup>91</sup> 805 ILL. COMP. STAT. § 10-10(c) (2014); Ribstein & Keatinge, *supra* note 2, § 12.3 & n.20.

<sup>92</sup> See TEX. BUS. ORGS. CODE §§ 21.223 – 21.226 (West 2012).

<sup>93</sup> See TEX. BUS. ORGS. CODE § 101.002 (West 2012).

<sup>94</sup> See, e.g., *Wilson v. Davis*, 305 S.W.3d 57 (Tex. App.—Houston [1st Dist.] Aug. 14, 2009, no pet.); *see also*, e.g., *Bollore S.A. v. Import Warehouse, Inc.*, 448 F.3d 317 (5th Cir. 2006) (applying Texas law); *Zahra Spiritual Trust v. United States*, 910 F.2d 240, 244 (5th Cir. 1990) (applying Texas law); *Seghers v. Bizri*, 513 F. Supp. 2d 694 (N.D. Tex. Mar. 7, 2007).

<sup>95</sup> See, e.g., *In re Moore*, 608 F.3d 253, 258-59 (5th Cir. 2010) (applying Texas law) (holding that reverse piercing claims against a bankrupt debtor's LLC were owned by the trustee and thus transferable by the trustee to another); *In re Juliet Homes, LP*, No. 09-03429, 2011 WL 6817928, at \*18-20 (Bankr. S.D. Tex., Dec. 28, 2011) (rejecting motion to dismiss a reverse veil-piercing claim against both several individuals and several entities, including a LLC); Ribstein & Keatinge, *supra* note 2, § 12.3 n.28.

<sup>96</sup> E.g., *In re Moore*, 379 B.R. 284, 294-95 (Bankr. N.D. Tex., Nov. 15, 2007).

all seem like winning arguments until we recall other arguments: Section 101.002, while proclaiming itself subject to 101.114, also imposed on LLCs law that could only apply if 101.114 is not taken at face value. Section 101.114 has never been taken at face value by the courts. Section 101.113 has never been applied. The second part of 101.114 has also never been applied. Now our heads are spinning. If we took all of this language seriously, our heads would continue to spin.

Fixing this twisted area of the law could be relatively simple, but those who have composed it and applied it will have to reach some agreement on basic principles. The first proposition on which those involved should agree is that—

#### **A. The Possibility of LLC Veil-Piercing Should Be Allowed.**

Ultimately, the legislature cannot and should not stop veil-piercing (or a similar remedy) when it is truly appropriate. Moreover, this seems to be nearly universally acknowledged.

##### **1. *The Court's Equitable Power to Stop Fraud Requires Veil-Piercing.***

With respect to limited liability companies, veil-piercing law is equitable,<sup>97</sup> meaning that its foundation is in the courts' equitable power to correct the application of a law that would allow the perpetration of a fraud. *Hooks v. Bridgewater* discussed the courts' equitable power:

It is clear that to warrant equity's 'breaking through the statute' . . . , the case must be such that . . . the enforcement of the statute . . . would, itself, plainly amount to a fraud. This is the basis, and the only basis, for the jurisdiction which courts of equity have assumed in their creation of exception to the statute. When it is considered that the exercise of that jurisdiction results in any case in practically setting the statute aside, certainly there should exist some positive rule which will insure its exercise for only the prevention of an actual fraud as distinguished from a mere wrong, and by which the question of whether [enforcing the statute] would result in such a fraud may be determined so surely as to leave the statute itself, through the exactness of the exception, with some definiteness of operation.<sup>98</sup>

This is the only basis for the numerous equitable exceptions to the Statute of Frauds discussed above in Section I.A. The Statute of Frauds by its terms prevents the enforcement of an oral contract, but the courts pursuant to equitable powers correct the law by making an exception.

The exception to limitations on corporate veil-piercing rests on this power. The language above from *Hooks* could have been written as a justification for section 21.223(b). The veil-

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<sup>97</sup> *E.g.*, *Castleberry v. Branscum*, 721 S.W.2d 270, 271 (Tex. 1986) ("when the corporate form has been used as part of a basically unfair device to achieve an inequitable result"), *superseded in part by*, TEX. BUS. ORGS. CODE § 21.223 (West 2012); *Tryco Enters., Inc. v. Robinson*, 390 S.W.3d 497, 510 (Tex. App.—Houston [1st Dist.] 2012, no pet.) (quoting *Castleberry*, 721 S.W.2d at 273); *Shook v. Walden*, 368 S.W.3d 604, 611-12 (Tex. App.—Houston [1st Dist.] 2012, pet. denied) ("disregarded as a matter of equity"). When veil-piercing is grounded in equity, many jurisdictions refuse a jury trial right for it. *E.g.*, Sam F. Halabi, *Veil-Piercing's Procedure*, 67 RUTGERS L. REV. \_\_\_\_ (2015), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2490647](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2490647) (Sept. 2, 2014).

<sup>98</sup> *See, e.g.*, *Hooks v. Bridgewater*, 229 S.W. 1114, 1116 (Tex. 1921).

piercing limitations in the corporate code meant to limit the courts' veil-piercing activities, and section 21.223(a) is the vehicle for limitation. But section 21.223(b) recognizes that legislation cannot force courts to allow the law to countenance the perpetration of fraud, so there must be an exception to the limitation. The exception is a "positive rule which will insure its exercise for only the prevention of an actual fraud as distinguished from a mere wrong, and by which the question of whether enforcing the statute would result in such a fraud may be determined so surely as to leave"<sup>99</sup> the separateness of corporate entities intact, with some definiteness of operation. In other words, the legislature recognizes in section 21.223(b) that veil-piercing rests ultimately on a moral and jurisprudential obligation of the courts. It could only be limited so far.

The exact same concerns animate the liability of LLC members for LLC obligations. Sometimes, the imposition of liability on a LLC member is the only way to remedy fraud. When it is, following section 101.114 or 101.113 would be to countenance fraud. A court is not required to do this, and a statute authorizing courts to protect fraudulent behavior would be odious.

## **2. *Veil-Piercing of LLCs Is the Universal Rule Nationally.***

I have found no dissent from the proposition that the veil of limited liability companies should be pierced given the right circumstances. Though arguments continue about which circumstances are proper, no one now argues for an absolute prohibition; remarkable agreement exists among commentators and cases that if the circumstances demand it members should be liable for the obligations of the LLC.<sup>100</sup> Such uniformity was not foreordained when the Texas LLC code was first passed in 1991,<sup>101</sup> but at this late date an absolute prohibition against veil-piercing of LLCs is a lost battle.

## **B. Equity Can Be Described and Contained by Statute.**

Historically, when courts have adopted positions in equity that made exceptions to the application of statutes, legislatures have often stepped up to correct the legislation that made possible the circumstances demanding departure from statutory language. Examples of legislative adoption of an equitable position include the doctrine of unconscionability in

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<sup>99</sup> *Id.* at 128. Peter Oh reports that veil-piercing claims in contract "prevail most often when couched in Fraud. The veil-piercing rate for Fraud exceeds that of any other type of civil substantive claim, in federal or state court as well as across all levels of courts." Peter Oh, *Veil-Piercing*, 89 TEX. L. REV. 81, 125 (2010).

<sup>100</sup> See, e.g., Bishop & Kleinberger, *supra* note 46; Ribstein & Keatinge, *supra* note 2, at § 12.3; Miller & Ragazzo, *supra* note 4, at § 20:7; Miller, *supra* note 4, at 416-19; Jeffrey K. Vandervoort, *Piercing the Veil of Limited Liability Companies: The Need for a Better Standard*, 3 DEPAUL BUS. & COM. L.J. 51 (2004); Rebecca J. Huss, *Revamping Veil Piercing for All Limited Liability Entities: Forcing the Common Law Doctrine into the Statutory Age*, 70 U. CIN. L. REV. 95 (2001); Robert B. Thompson, *The Limits of Liability in the New Limited Liability Entities*, 32 WAKE FOREST L. REV. 1 (1997); Robert R. Keatinge, et al, *The Limited Liability Company: A Study of the Emerging Entity*, 47 BUS. LAW. 375, 445 (1992); Wayne M. Gazur & Neil M. Goff, *Assessing the Limited Liability Company*, 41 CASE W. RES. L. REV. 387, 403 (1991). Ribstein and Keatinge in particular cite at length cases from around the nation. See Ribstein & Keatinge, *supra* note 2, at § 12.3 n.1. (One can search for hours and not find a single dissenting voice.)

<sup>101</sup> 2013 Bill Tex. H.B. 278 (1991).

contracts;<sup>102</sup> statutes authorizing equitable remedies such as injunctions,<sup>103</sup> declaratory judgments,<sup>104</sup> and receiverships;<sup>105</sup> trust law;<sup>106</sup> fiduciary duty law;<sup>107</sup> and the corporate statute allowing veil-piercing notwithstanding limits.<sup>108</sup> No reason exists that legislation could not also establish, structure, and clarify veil-piercing for the LLC.

### C. The LLC Code Can Limit Veil-Piercing in a Simple Way.

An irony exists in a legislative attempt to curb judicial power that itself corrects absurd consequences of legislation. The legal history of veil-piercing in Texas looks like a slow brawl between proponents and opponents of veil-piercing's breadth. The courts took the first swing with *Castleberry*—broad. The legislature struck back with the predecessor of section 21.223—narrow. The legislature took another swing with sections 101.113 and 101.114—so narrow as to be non-existent. The courts swung back with decisions that applied veil-piercing to LLCs, but on the principles set forth in section 21.223—relatively broad. With the latest legislation, both sides are holding on to their opponent—sections 101.113, 101.114, and the preamble to section 101.002 suggesting no veil-piercing should occur; and the rest of section 101.002 and the courts suggesting that veil-piercing should continue on section 21.223 principles. With the two sides' arms tied up, and no referee to separate them, litigants and courts should wonder what will happen next.

But with clarity that no absolute prohibition of LLC veil-piercing should exist and with confidence that the statute can set the boundaries, as does the corporate code, some decisions can be reached.

To start, the statute should discard the absolute prohibition of section 101.114. Courts have both the power and the obligation to disregard it in the proper circumstances, anyway, so the incoherence it brings to the law serves only wishful thinking. Clarifying that it does not preclude veil-piercing would also bring Texas law into line with the rest of the nation. One way to do this would be to adopt the Uniform Act's "solely by reason of being . . . a member" language,<sup>109</sup> which allows the egregious facts of veil-piercing cases to fall outside of the prohibition.

Second, section 101.002's qualifier "[s]ubject to Section 101.114" should be repealed. Section 101.114 is phrased as an absolute prohibition, and that condition renders section

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<sup>102</sup> See TEX. BUS. & COM. CODE § 2-302 (West 2012). For an early example of unconscionability in equity in a contracts case, see *Luckett v. Townsend*, 3 Tex. 119, 131 (1848). The Texas Supreme Court now turns to the UCC's sale of goods provision on unconscionability to give guidance on unconscionability even outside the context of the sale of goods. See *Venture Cotton Co-op v. Freeman*, 435 S.W.3d 222 (Tex. 2014).

<sup>103</sup> TEX. CIV. PRAC. & REM. CODE §§ 65.001-65.045 (West 2012).

<sup>104</sup> TEX. CIV. PRAC. & REM. CODE §§ 37.001-37.011 (West 2012).

<sup>105</sup> TEX. BUS. ORGS. CODE §§ 11.401-11.414 (West 2012).

<sup>106</sup> TEX. BUS. ORGS. CODE chs. 101, 111, 112, 113, 114 & 115 (West 2012). The early history of trust law's development in equity is reported in David J. Seipp, *Trust and Fiduciary Duty in the Early Common Law*, 91 BOSTON UNIV. L. REV. 1011 (2011).

<sup>107</sup> E.g., TEX. BUS. ORGS. CODE §§ 7.001, 101.255, 101.401, 152.204, 152.205, 152.206 (West 2012).

<sup>108</sup> TEX. BUS. ORGS. CODE § 21.223(b) (West 2012).

<sup>109</sup> See *supra* note 2.

101.002 a contradiction. If section 101.114 was amended so that it was no longer an absolute prohibition, section 101.002 would not need to be subject to it.

Third, section 101.113 should be repealed. It is at best an indirect attempt at regulating veil-piercing via procedure on the off chance that the absolute prohibition of section 101.114 is ineffective. Section 101.113's procedural hurdle is so counter-intuitive that for two decades while the statute sat on the books no court suspected its substance and no lawyer raised it to the court! Direct regulation of the substance of the law is a much better course. Moreover, section 101.113 runs the risk of forcing the courts to allow fraud in the management of the LLC, and courts have an obligation to stop a statute intended to encourage investment and increase business efficiency from having the opposite effect of encouraging fraud.

These changes would go a long way toward fixing the statute. I doubt the remaining problems would warrant mention in print if these were fixed. But as long as we are at it, why not try to mend a few remaining problems?

If section 101.114 is to lose its absolute prohibition, then what form should it take? One possible form is the Uniform Act's, already noted.<sup>110</sup> Another form would be to list exceptions; in other words, capture the equitable position in legislation to give equity effect, structure, and content. The narrowest form this might take is to list the ground of equitable jurisdiction itself:

(a) Except as and *only* to the extent *provided in subsection (b) or that* the company agreement specifically provides otherwise, a member . . . is not liable for a debt, obligation, or liability of a limited liability company, including a debt, obligation, or liability under a judgment, decree, or order of a court.

(b) *A member is liable for the debt, obligation, or liability of a limited liability company, including a debt, obligation, or liability under a judgment, decree, or order of a court if the member has used the limited liability company to perpetrate a fraud with intent to deceive primarily for the direct personal benefit of the member and against the person to whom the debt, obligation, or liability is owed. A limited liability company shall be liable for the debt, obligation, or liability of a member only on the same principle.*

There are several benefits to this formulation. For instance, it does not use the muddled phrase "actual fraud"; the circularity and ambiguity of section 21.223's use of that phrase is avoided. Second, "other theories" are not mentioned. It is clear that only this narrow case will warrant liability. Third, though formalities are not mentioned, they would only be of use in a veil-piercing case to the extent they are relevant to the issue at hand, which is to the extent that failure to observe them is evidence of the elements of the new section 101.114(b). That is their proper place, in fact. Reverse piercing is also addressed. If this method of direct regulation is chosen, section 101.002 should also be repealed.

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<sup>110</sup> See *supra* text accompanying note 110.

Perhaps this proposal is too narrow and too broad. For contractual obligations, perhaps it is too broad. The law now requires that litigants satisfy not only this minimal test for equitable jurisdiction, but also the traditional test for veil piercing, from *Castleberry*.<sup>111</sup> Of course, this is easily fixed by including that traditional test, making veil-piercing available as follows:

(a) Except as and *only* to the extent *provided in subsection (b) or that* the company agreement specifically provides otherwise, a member . . . is not liable for a debt, obligation, or liability of a limited liability company, including a debt, obligation, or liability under a judgment, decree, or order of a court.

(b) *A member is liable for the contractual debt, obligation, or liability of a limited liability company, including a debt, obligation, or liability under a judgment, decree, or order of a court if the member has used the limited liability company*

(i) *as part of a basically unfair device to achieve an inequitable result, and*

(ii) *to perpetrate a fraud with intent to deceive primarily for the direct personal benefit of the member and against the person to whom the debt, obligation, or liability is owed.*

*A limited liability company shall be liable for the debt, obligation, or liability of a member only on the same principle.*

(c) *A member's failure to observe any formality of law or agreement in the operation of the limited liability company is not itself a ground for member liability but may, if relevant, contribute to a finding of unfairness or inequity.*

Knowledgeable readers will recognize the language from the Texas Supreme Court's latest pronouncement of the standards for shareholder liability for a corporate debt,<sup>112</sup> with an added sentence to deal with formalities. That should suffice to counter the objection; the case law fills out the meaning of the general test. The only exception is that this proposal handles the law of formalities as a relevance question, which it should be.<sup>113</sup> This would be more reflective of current corporate law, but requiring plaintiffs to show both (i) and (ii) has always seemed redundant to me. Subsection (ii) is the more difficult showing, and if subsection (ii) is shown, the courts should pierce regardless of whether (i) is true, so it would be appropriate to drop (i) and allow contractual and non-contractual liability to be regulated somewhat differently.

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<sup>111</sup> See, e.g., *supra* note 97.

<sup>112</sup> SSP Partners v. Gladstrong Invs. (USA) Corp., 275 S.W.3d 444, 451 (Tex. 2009) (*citing Castleberry v Branscum*, 721 S.W.2d 270, 271 (Tex. 1986)).

<sup>113</sup> *Contra* TEX. BUS. ORGS. CODE § 21.223(a)(3) (West 2012). The difference, of course, is that here proof of failure to observe formalities is allowed if that is actually relevant to prove the case. The proposal tries to eliminate the confusion inherent in 21.223(a)(3) as currently worded.

Some may feel the proposal too narrow with respect to tort and other non-contractual liability. After all, the corporate statute treats shareholder liability for torts differently from contractual liability; imposition of tort liability requires proof of traditional judge-made veil-piercing law (minus failure to observe formalities),<sup>114</sup> while contractual liability requires the same proof plus a showing that the shareholder used the corporation “for the purpose of perpetrating and did perpetrate an actual fraud on the obligee primarily for the direct personal benefit of” the shareholder.<sup>115</sup> It is possible to subject tort liability to the same criteria as contract liability.

But that may be too narrow. Is fraud the only possible absurd consequence of an absolute prohibition on LLC veil-piercing? I do not know, and I suppose reasonable minds may differ. After all, the tort victim is seldom able to calculate the risk of dealing with the LLC in a manner similar to one who enters into a contract with it. Tort victims do not choose their status at all. Setting up a LLC with little or no capital in order to use it to commit torts with impunity is malicious or recklessly abusive in a manner similar to using the entity to perpetrate an intentional fraud, but it is not necessarily an actual fraud. If the legislature feels that tort liability veil-piercing against LLC members should more resemble the corporate context, then the proposal could be modified to include that substance, so that another recommended proposal looks like this:

- (a) Except as and *only* to the extent *provided in subsection (b) or (c) or that* the company agreement specifically provides otherwise, a member . . . is not liable for a debt, obligation, or liability of a limited liability company, including a debt, obligation, or liability under a judgment, decree, or order of a court.
- (b) *A member is liable for the contractual debt, obligation, or liability of a limited liability company, including a debt, obligation, or liability under a judgment, decree, or order of a court if the member has used the limited liability company to perpetrate a fraud with intent to deceive primarily for the direct personal benefit of the member and against the person to whom the debt, obligation, or liability is owed. A limited liability company shall be liable for the debt, obligation, or liability of a member only on the same principle.*
- (c) *A member is liable for the non-contractual debt, obligation, or liability of a limited liability company, including a debt, obligation, or liability under a judgment, decree, or order of a court if the member has used the limited liability company as part of a basically unfair device to achieve an inequitable result.*
- (d) *A member’s failure to observe any formality of law or agreement in the operation of the limited liability company is not itself a ground for member liability but may, if relevant, contribute to a finding of fraud, unfairness, or inequity.*

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<sup>114</sup> See, e.g., TEX. BUS. ORGS. CODE §§ 21.223(a), 21.224 (West 2012).

<sup>115</sup> *Id.* § 21.223(b).

With regard to tort liability, I see little difference between the position of the LLC member and the corporate shareholder, or at least none that makes the law difficult to apply as it does in the contractual liability context given the language and conceptual structure of section 21.223.

With these larger issues addressed, I will conclude by urging action. I have shown, I hope, that the statute must be improved, and that it can be. No doubt more could be said on these issues; surely others will contribute. I mean here only to describe the problem and point toward a simpler, more internally consistent solution. In its current state, the Texas law of veil-piercing for LLCs does not need further description. It does not deserve further description. It deserves to be changed.



# PRACTICAL TIPS FOR DRAFTING CONTRACTS AND AVOIDING ETHICAL ISSUES

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## I. INTRODUCTION

A newly licensed attorney responds to an ad for a “transactional attorney” believing she has a good chance to be the selected candidate given her prior experience. When she calls to inquire about the job, the first question the recruiter asks is, “What experience do you have negotiating transactions?” The newly licensed attorney replies, “My background in transactions is extensive. I negotiated numerous healthcare information technology contracts as a consultant before I started law school and since becoming licensed, I’ve drafted and/ negotiated all sorts of contracts – from Employment and Severance Agreements to License and Purchase Agreements.” The recruiter replies, “All attorneys draft and negotiate contracts. What transactions experience do you have?”

Based on the recruiter’s response, he evidently considered only company mergers and acquisitions to be worthy of being called “transactions;” any and all other “deals” belonged in some other (probably lesser) category. Without question however, the two things these other “deals” and the recruiter’s “transactions” have in common is that (1) most, if not all of them ultimately wind up formalized in some sort of written agreement, and (2) all of them are transactions. Still, his claim that all attorneys draft and negotiate contracts is absolutely correct. Even attorneys who spend the majority of their time trying cases occasionally find themselves drafting contracts – they’re just called “settlement agreements” in the litigation world.

Despite the fact that all attorneys wind up drafting contracts at some point in their careers, very few of them, even those who consider themselves transactional attorneys, learned *how* to draft them in law school. Unlike other types of writing – legal or otherwise – contracts “do not entertain, do not convey information or ideas, and do not try to persuade.”<sup>1</sup> Why then is it so difficult to draft them?

Mature law students, those who had some business experience prior to law school, might have been exposed to contract drafting in their prior career, but even they concede that being exposed to drafting contracts does not necessarily prepare them to *competently* draft them. More often than not, the best way to develop the skills and expertise they need to competently draft contracts is to actually draft them; in other words, obtain some “on the job” training.

The good news is, most attorneys will be exposed to all sorts of contracts regardless of whether they are part of a large law firm, in a mid-size or small law firm, a solo practitioner, or even an in-house counsel for a business. The bad news is that there are very few (if any) opportunities for new lawyers to find someone to train him/her to competently draft contracts, even within the new lawyer’s own office.

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<sup>1</sup> Peter Siviglia, *Designs for Courses on Drafting Contracts*, 12 SCRIBES J. LEGAL WRITING 89, 89 (2008–2009).

No two businesses are the same, the client objectives associated with each deal vary widely (sometimes at different times in the same deal), and a provision that is acceptable to one client can be the source of a contentious dispute for another. Every contract is different – even though every contract uses the same contract concepts.<sup>2</sup> The process of creating a contract, too, is relatively straight-forward and simple, but with some clients, may actually be (or become) convoluted and complex. Achieving expertise in contract drafting is partly a function of the types, how many, how complex, and the length of contracts the attorney drafts, but it's also dependent on the training, skills, and knowledge the attorney obtains along the way and the clients the attorney represents. It's also important to recognize some of the traps and pitfalls that await even an experienced transactional attorney – so these problems can be resolved quickly or avoided if possible. This article describes why and how drafting contracts differs from drafting other legal documents, presents a few of the more common ethical traps an attorney drafting contracts might encounter, and provides practical tips designed to help attorneys who draft, review, and change contracts minimize the impact of or avoid making mistakes altogether.

## II. DRAFTING CONTRACTS VS. DRAFTING OTHER LEGAL DOCUMENTS

There are at least three different forms of writing: (1) *creative writing*, which includes “novels, plays, and poetry;” (2) *expository writing*, which includes “treatises, letters, memorandums [sic], and briefs;”<sup>3</sup> and (3) *legal drafting*, the form that is used when drafting contracts. All three are used by attorneys, but only the last two are used by practicing attorneys.<sup>4</sup>

Expository writing, sometimes referred to as *legal writing*, is distinguishable from contract drafting, which is a specific subcategory of legal drafting.<sup>5</sup> Traditionally a required course at most law schools, legal writing classes teach law students to write letters, briefs, and legal memoranda;<sup>6</sup> writing that explains and persuades.<sup>7</sup> On the other hand, legal drafting, specifically contract drafting, is rarely taught – unless as a small component of a legal writing or survey

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<sup>2</sup> TINA L. STARK, DRAFTING CONTRACTS: HOW AND WHY LAWYERS DO WHAT THEY DO 9 (2nd ed. 2013).

According to Professor Stark, there are seven “building blocks” that serve as the foundation of every contract: (1) Representations, (2) Warranties, (3) Covenants, (4) Rights, (5) Conditions, (6) Discretionary authority, and (7) Declarations. *Id.*

<sup>3</sup> Siviglia, *supra* note 1, at 89.

<sup>4</sup> Erle Stanley Gardner, John Grisham, Scott Turow, Meg Gardiner, Sir John Clifford Mortimer, CBE, QC, Richard North Patterson, Wallace Stevens, John Buchan, Louis Auchincloss, and Henry Fielding are lawyers who specialize in creative writing. Richard Davies, *10 Lawyers Who Became Authors*, ABEBOOKS (Apr. 6, 2009), <http://www.abebooks.com/books/john-grisham-perry-mason/authors-literary-lawyers.shtml>.

<sup>5</sup> The other subcategories included in *legal drafting* are instruments, statutes, and regulations. See Wayne Schiess, *What Plain English Really Is*, 9 SCRIBES J. LEGAL WRITING 43, 44 (2003–2004).

<sup>6</sup> See Jane Scott & Charles Fox, *Contract Drafting in 90 Minutes*, 12 TRANSACTIONS: TENN. J. BUS. L. 7, 16-17 (2011); Schiess, *supra* note 5, at 44.

<sup>7</sup> Brian M. Kubicki, *The Practice of Writing*, RES GESTAE, Sept. 2008, at 40, 40.

class<sup>8</sup> – and results in documents that are “unmistakable [and] not interesting.”<sup>9</sup> Legal writing focuses on historical events; legal drafting on future behavior.<sup>10</sup> Legal writing describes “a specific event that occurred and its known ramifications;”<sup>11</sup> legal drafting “must anticipate myriad circumstances that may arise as the future unfolds.”<sup>12</sup> Statutes and cases are cited, quoted, and argued in briefs and pleadings; contracts may include citations to statutes, but neither quote nor argue them and almost never reference specific cases.<sup>13</sup> Another key difference between legal writing and legal drafting is that each word or provision in a contract may be subjected to greater scrutiny and challenge by opposing counsel whereas the meanings of words or phrases in a brief or pleading are rarely the primary target or focus of even the most zealous advocate.<sup>14</sup> But the most significant differences between legal writing and legal drafting are (1) the intended audience of each form of writing; and (2) the way each type of document is created and produced.

Memoranda, briefs, and pleadings are designed to be read by lawyers and judges; contracts should be written so they can be read, understood, and used by non-lawyers.<sup>15</sup> Contracts are simply a “set of instructions for a transaction. . . , or for a relationship. . . , or for a combination of the two.”<sup>16</sup> Additionally, drafting contracts, unlike drafting documents that are designed to explain and persuade, is a much more collaborative process.<sup>17</sup> Rarely are contracts drafted from scratch.<sup>18</sup> Instead, lawyers look for similar contracts they or others have drafted in the past and then use these prior contracts as a starting point from which they create new and unique contracts that accurately describe a particular deal and the parties’ relationship in that deal.<sup>19</sup> Similarly, during the process of contract negotiations, lawyers from both sides of the deal contribute the language that is ultimately included in the final contract.<sup>20</sup>

One author explains, “we have to learn different skills for different styles of writing. We have to set aside the habits developed under one style when we write in another. Otherwise, our briefs become unpersuasive and our contracts imprecise.”<sup>21</sup> He further states that attorneys also

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<sup>8</sup> See LENNÉ EIDSON ESPENSCHIED, CONTRACT DRAFTING: POWERFUL PROSE IN TRANSACTIONAL PRACTICE 1 (2010) (explaining that law schools have only recently begun to offer legal drafting courses); Gregory M. Duhl, *Conscious Ambiguity: Slaying Cerebus in the Interpretation of Contractual Inconsistencies*, 71 U. PITTS. L. REV. 71, 74-75 (2009) (hereinafter “Duhl-2009”) (stating that law schools fail to train students in contract drafting); Siviglia, *supra* note 1, at 89 (suggesting that one of the reasons for not offering separate courses to teach legal drafting is because such courses are difficult to teach and labor-intensive).

<sup>9</sup> Kubicki, *supra* note 7, at 40.

<sup>10</sup> ESPENSCHIED, *supra* note 8, at 6.

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*; see also Harold A. Segall, *Drafting: An Essential Skill*, 30 FORDHAM URB. L.J. 751, 753 (2003).

<sup>13</sup> ESPENSCHIED, *supra* note 8, at 7.

<sup>14</sup> *Id.*

<sup>15</sup> *Id.*

<sup>16</sup> Siviglia, *supra* note 8, at 90.

<sup>17</sup> See ESPENSCHIED, *supra* note 8, at 7.

<sup>18</sup> *See id.*

<sup>19</sup> *See id.* at 7-8.

<sup>20</sup> *See id.* at 8.

<sup>21</sup> Kubicki, *supra* note 7, at 40 (2008).

“have an ethical obligation to write well.”<sup>22</sup> This obligation is expressed in the ABA Model Rules of Professional Conduct (the Model Rules),<sup>23</sup> albeit “only tangentially or by analogy”<sup>24</sup> as the Model Rules are biased towards and “primarily address ethical issues that arise in litigation.”<sup>25</sup>

### III. COMMON ETHICAL ISSUES IN CONTRACT DRAFTING

The Model Rules were designed to meet the specific challenges that arise in an adversarial system. “[T]hey presume adverse parties, zealous advocates, and a neutral tribunal.”<sup>26</sup> By contrast, much of a transactional attorney’s work is cooperative, not competitive.<sup>27</sup> Drafting a contract that is fair to both parties is paramount, as is ensuring that the contract accurately reflects the intent of each of the parties to it.<sup>28</sup> “Litigation is audible, visible, and takes place in a public forum where the proceedings are recorded. Transactions are generally negotiated in the privacy of a conference room, and contracts drafted in the privacy of an office. Because no record is made, disciplining a lawyer becomes much more difficult.”<sup>29</sup> Still, the Model Rules provide some guidance to the transactional attorney in three specific areas: competence, division of responsibilities, and avoiding fraud.

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<sup>22</sup> *Id.*

<sup>23</sup> All citations to the Model Rules are to the 2012 American Bar Association Model Rules of Professional Conduct, [http://www.americanbar.org/groups/professional\\_responsibility/publications/model\\_rules\\_of\\_professional\\_conduct/model\\_rules\\_of\\_professional\\_conduct\\_table\\_of\\_contents.html](http://www.americanbar.org/groups/professional_responsibility/publications/model_rules_of_professional_conduct/model_rules_of_professional_conduct_table_of_contents.html) (last visited August 8, 2014). For the remainder of this article, however, references will be to the Texas Disciplinary Rules of Professional Conduct.

<sup>24</sup> STARK, *supra* note 2, at 455.

<sup>25</sup> *Id.*; see also Scott J Burnham, Larry A DiMatteo, Kenneth A. Adams, & J. Lyn Entrikin Goering, *Transactional Skills Training: Contract Drafting – Beyond The Basics*, 2009 TRANSACTIONS: TENN. J. BUS. L. 253, 282 (2009); Gregory M. Duhl, *The Ethics of Contract Drafting*, 14 LEWIS & CLARK L. REV. 989, 995 (2010) (hereinafter “Duhl-2010”); Tina L. Stark, *Ethics of Drafting Agreements*, 205 PLI/CRIM 127, 127 (July 2006); Martin H. Malin, *Ethical Concerns in Drafting Employment Arbitration Agreements After *Circuit City* and *Green Tree**, 41 BRANDeIS L.J. 779, 806 (2003). Professor Stark comments that transactional attorneys who encounter ethical problems are provided only a “paucity of rules” that is exacerbated by the “paucity of case law and ethical opinions.” STARK, *supra* note 2, at 456.

<sup>26</sup> Duhl-2010, *supra* note 25, at 995.

<sup>27</sup> *Id.* at 994; see also Siviglia, *supra* note 1, at 97 (2008-2009) (describing the goal of contract drafting as not winning, but rather making a deal between two or more parties that reflects the intent of each). The competitive aspect arises when each client’s attorney is trying to achieve the best possible outcome for his/her particular client. While the ultimate goal (of reaching an agreement) is the same for both sides, each side strives to “win” just a little bit more than the other side or one attorney strives to protect his/her client from all possible risk.

<sup>28</sup> Siviglia, *supra* note 1, at 96-97. According to Mr. Siviglia, the reasons for drafting a fair contract are obvious and simple:

A one-sided contract will invariably be negotiated back to the middle.

An evenhanded contract will result in minimal, non-confrontational negotiation and a quick conclusion of the deal.

An evenhanded contract, raising few issues, will cost the client less in legal fees.

*Id.* at 97.

<sup>29</sup> STARK, *supra* note 2, at 456. The reasons for the difficulty in disciplining attorneys for poor contract drafting is that it’s the attorney’s client who ultimately suffers. See ESPENSCHIED, *supra* note 8, at 21. Incorrectly drafted or incomprehensible provisions in a contract can result in unwanted and unintended liability to the client, failure to achieve a desired benefit, and even higher legal fees. *Id.* Most importantly, however, if a contract dispute cannot be resolved without litigation, the business and working relationship between the parties is likely to be irreparably damaged. *Id.*

### A. Competence

Many attorneys in transactional practices are reluctant to agree to represent a client whose business is unfamiliar to the attorney, or to draft contracts where the subject matter is new to them. More likely than not, the underlying concern they have is that they do not have the requisite competence required by the appropriate disciplinary rules to effectively represent clients whose business they know little or nothing about or draft contracts they've never previously drafted. While this concern is admirable, it is also misplaced.

Texas Rule 1.01(a) provides, “A lawyer shall not accept or continue employment in a legal matter which the lawyer knows or should know is beyond the lawyer’s competence representation to a client.”<sup>30</sup> Competence is defined as “possession of the legal knowledge, skill and training reasonably necessary for the representation.”<sup>31</sup> To meet that definition, the attorney must have an understanding of how to study and analyze both the law and facts,<sup>32</sup> how such understanding is to be applied on behalf of the client,<sup>33</sup> and a thorough grounding in contract law.<sup>34</sup> He or she does not necessarily need to have special training or prior experience to handle legal problems of a type with which he or she is unfamiliar in order to be considered competent<sup>35</sup> as many specific legal skills are common in all legal problems.<sup>36</sup> Determining what legal problems exist alone is “a skill that necessarily transcends any particular specialized knowledge.”<sup>37</sup> A competent attorney can provide adequate representation through additional study and investigation provided such additional study and investigation does not unusually delay the attorney’s providing services to the client or cost the client more for the representation.<sup>38</sup> Failure to have or to gain the requisite expertise, however, may result not only in disciplinary action against the attorney, but also liability for malpractice.<sup>39</sup>

### B. Division of Responsibilities

Many transactional attorneys are more comfortable arguing about the meaning of an individual word, the placement of a comma, or whether a single provision (out of a total of fifty or more in the entire contract) should be included in or deleted from a contract than they are about understanding the reasons for or negotiating the contract as a whole. After all, law school

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<sup>30</sup> TEX. DISCIPLINARY RULES PROF’L CONDUCT R. 1.01(a), *reprinted in* TEX. GOV’T CODE ANN., tit. 2, subtit. G, subchap. A, app. (2013) (TEX. STATE BAR R. art. X, § 9). TEX. DISCIPLINARY RULES PROF’L CONDUCT R. 1.01(a).

<sup>31</sup> TEX. DISCIPLINARY RULES PROF’L CONDUCT R. 1.01(a) cmt. 1.

<sup>32</sup> TEX. DISCIPLINARY RULES PROF’L CONDUCT R. 1.01(a) cmt. 1.

<sup>33</sup> TEX. DISCIPLINARY RULES PROF’L CONDUCT R. 1.01(a) cmt. 1.

<sup>34</sup> STARK, *supra* note 2, at 379. “Thorough grounding in contract law” in this context means the attorney would know why a provision should be drafted as a covenant, not as a condition. *Id.*

<sup>35</sup> TEX. DISCIPLINARY RULES PROF’L CONDUCT R. 1.01(a) cmt. 3.

<sup>36</sup> TEX. DISCIPLINARY RULES PROF’L CONDUCT R. 1.01(a) cmt. 3.

<sup>37</sup> TEX. DISCIPLINARY RULES PROF’L CONDUCT R. 1.01(a) cmt. 3. Having subject matter expertise in a field of law or industry and/or understanding the business concepts implicated in a particular transaction are also extremely valuable to the client. TINA L. STARK, DRAFTING CONTRACTS: HOW AND WHY LAWYERS DO WHAT THEY DO 379 (2007).

<sup>38</sup> TEX. DISCIPLINARY RULES PROF’L CONDUCT R. 1.01(a) cmt. 4. An attorney should not charge his or her client for the hours the attorney spends “learning” what’s necessary to provide “adequate representation.” *Id.*

<sup>39</sup> STARK, *supra* note 2, at 457.

rewards students for being detail-oriented and for being able to take a position and argue it from numerous perspectives. Thus, it is not surprising that a transactional attorney might fail to inquire about or take the time to discover his/her client's objectives for entering into a contractual relationship. According to Comment 1 of Texas Rule 1.02, however, the client is responsible for establishing the representation's objectives; the attorney is responsible for determining the "means by which the client's objectives are best achieved."<sup>40</sup> In other words, understanding the client's business objectives in making the deal is critical to ensuring that the final contract protects and advances the client's interests.<sup>41</sup>

Beyond understanding the client's business objectives, however, the attorney may need to understand the particulars about the transaction itself so that individual provisions within the final contract support and ensure the client's achieving its goals.<sup>42</sup> Becoming knowledgeable about the particulars of the transaction will help the attorney's focus his/her research for applicable laws, understanding the industry's customs and jargon will help the attorney identify likely issues that might impact the client or the transaction, and finding similar contracts from which critical provisions can be obtained will enable the attorney to draft a contract that advances the client's interests.<sup>43</sup> When transactional attorneys refuse to leave their own comfort zone (because they choose to argue only minute details or to draft provisions that completely shield a client from any possible risk), they jeopardize the successful completion of the contract process and ultimately prevent the client from ever achieving its objectives.

### C. Avoiding Fraud

While the majority of transactional attorneys' work is non-adversarial and collaborative, they must insert themselves into the contract process and "explore inconsistencies, challenge positions, battle ambiguities, and raise uncomfortable issues."<sup>44</sup> When they do, they are more than just advocates for their clients; they become educators, wordsmiths, and scriveners as well.<sup>45</sup> This combination of roles "presents unique ethical challenges for the transactional [attorney];"<sup>46</sup> thus, it may cause the transactional attorney to inadvertently engage in professional misconduct.

When a transactional attorney is instructed by his/her client to include fraudulent representations in a contract and then knowingly drafts them, the transactional attorney violates Texas Rule 1.02(d) which requires an attorney to "make reasonable efforts under the circumstances to dissuade the client from committing . . . fraud."<sup>47</sup> If, instead of being instructed

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<sup>40</sup> TEX. DISCIPLINARY RULES PROF'L CONDUCT R. 1.02(a) cmt. 1.

<sup>41</sup> See Ronald B. Risdon, *Drafting Corporate Agreements 2000-2001: Universal Issues*, 1219 PLI/CORP 9, 11 (2000) (hereinafter "Risdon-2000"); see also ESPENSCHIED, *supra* note 8, at 69.

<sup>42</sup> See Scott J. Burnham, *Transactional Skills Training: Contract Drafting – Beyond The Basics*, 2009 TRANSACTIONS: TENN. J. BUS. L. 253, 255 (2009). See also Noric Dilanchian, *6 principles for drafting good contracts*, <http://enterprisehub.com/articles/legal/255-6-principles-for-drafting-good-contracts/> (last visited Aug. 8, 2014).

<sup>43</sup> ESPENSCHIED, *supra* note 8, at 70.

<sup>44</sup> CHARLES M. FOX, *WORKING WITH CONTRACTS: WHAT LAW SCHOOL DOESN'T TEACH YOU* 66-67 (2002).

<sup>45</sup> Duhl-2010, *supra* note 25, at 991.

<sup>46</sup> *Id.*

<sup>47</sup> TEX. DISCIPLINARY RULES PROF'L CONDUCT R. 1.02(d).

to draft fraudulent representations in the contract, the representations are true when they are initially drafted but become false before the contract is executed, Texas Rule 4.01(b) requires that the transactional attorney counsel the client to disclose the resulting misrepresentations or disclose them to the opposing party himself/herself.<sup>48</sup>

A transactional attorney might be in violation of Texas Rule 8.04(a)(3) if he/she engages in “conduct involving dishonesty, fraud, deceit or misrepresentation.”<sup>49</sup> When a transactional attorney discovers a scrivener’s error and fails to disclose it to his/her client, allowing his/her client to capitalize on the error, or when a transactional attorney knowingly includes terms in a contract that differ from those agreed to by the parties, or when he/she fails to include terms that have been agreed upon, he/she might be found to have engaged in fraud under Texas Rule 8.04(a)(3).<sup>50</sup> If the transactional attorney drafts an invalid or unenforceable provision, one that is ambiguous, or one that the attorney believes, but does not know with any certainty, is lawful, he/she could be found to be acting dishonestly under Texas Rule 8.04(a)(3).<sup>51</sup>

With an understanding of the difference between legal writing and contract drafting and the ethical issues and problems to avoid, the remainder of this article provides practical tips that are designed to help attorneys draft complete and ethical contracts.

#### IV. PRACTICAL TIPS

##### A. Practical Tip #1: Understand the Deal and the Contract Process

Successful transactional attorneys will always determine the actual reason (or reasons) their client wants to enter into a contract. They will meet and talk with their client to understand what objectives the client is trying to achieve and to prioritize those objectives in order of importance.<sup>52</sup> They will also discuss whether entering into *this* contractual relationship will enable the client to achieve those objectives, whether the client will be able to achieve all of them, or whether one or more of the client’s objectives will have to be sacrificed.

The contract process typically begins with an interview with or a memorandum from a client in which the client explains the terms of the deal.<sup>53</sup> It is easier to discuss and identify the deal objectives face-to-face or over the telephone, but if a personal conversation is impossible or impractical, reviewing the terms may provide some insight into the desired objectives – which

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<sup>48</sup> Texas Rule 4.01(b) prohibits an attorney from “knowingly assisting a fraudulent act perpetrated by a client.” TEX. DISCIPLINARY RULES PROF’L CONDUCT R. 4.01(b).

<sup>49</sup> TEX. DISCIPLINARY RULES PROF’L CONDUCT R. 8.04(a)(3).

<sup>50</sup> See Duhl-2010, *supra* note 25, at 1001-04; Duhl-2009, *supra* note 8, at 109-110. See also ABA INFORMAL OP. 86-1518.

<sup>51</sup> Duhl-2010, *supra* note 25, at 1009-15.

<sup>52</sup> See Risdon-2000, *supra* note 41, at 9 (stating that the key to drafting successful agreements is understanding the business objectives of the client and the other parties to the deal); Ronald B. Risdon, *Drafting Corporate Agreements 1999: Converting the Deal into an Effective Contract a Satellite Program. Drafting Corporate Agreements: Universal Issues*, 1139 PLI/CORP 7, 9 (1999) (hereinafter “Risdon-1999”) (understanding the client’s objectives in a business deal is necessary to ensure that the client’s interests are protected and advanced).

<sup>53</sup> James W. Martin, *50 Tips for Writing the Contract That Stays Out of Court (with Forms)*, 14 No. 3 PRAC. REAL EST. LAW. 55, 56 (May 1998).

can be confirmed with the client at a later point in the contract process.

As soon as possible, the attorney should “engage [the] client in ‘what if’ scenarios”<sup>54</sup> and explore the various factual situations that might arise during the term of the contract. This will help identify issues that the client or the attorney might not have anticipated. Unresolved issues will also become apparent in the activities that take place between the beginning and the end of the contract process – developing or crafting the deal, drafting the initial contractual language, engaging in back-and-forth communications with the other side’s attorney as terms and issues are raised, discussed, and a mutually beneficial compromise is reached. During the process of reviewing, redlining, refining, and redrafting the contract so the client’s needs are addressed and properly articulated, and, most importantly, prior to obtaining signatures from the parties on the executed contract that accurately depicts the agreement between the parties, all these issues should be resolved.

Transactional attorneys should recognize that just because a document is a contract, it does not necessarily follow that they (as attorneys) are the only individuals necessary or critical to the company’s decision to proceed with or withdraw from the contract process. It is very likely that others within the company need to and/or will be involved in helping to ensure that the business deal is formally drafted and properly documented. The more regulated an industry, the more likely it is that one word in a contract will trigger the involvement of non-attorneys in the contract process. In addition, heightened scrutiny of and enforcement actions taken against businesses often result in the need to include “trigger words” in contracts and other business documents. Trigger words help the company minimize the risk of an enforcement agency examining the business’s records and operations to determine if enforcement actions are necessary. In addition, trigger words help the company identify those contracts that have to be reviewed in excruciating detail and approved not only by the company’s attorneys, but also by non-lawyer executives prior to their execution.

For example, a company might require that its internal or external auditors sign-off on a contract before it is executed if the provision that describes the right of one party to examine or review the books and records of the other party uses “audit” instead of either “examine” or “review.” Likewise, referring to regulations or regulatory requirements might mean that the company’s compliance officer as well as its general counsel needs to become involved in and approve the execution of the final contract.

## **B. Practical Tip #2: Template Contracts vs. Contracts Drafted From Scratch**

With apologies to Frank Zappa and The Mothers of Invention, “One size does not fit all.” Attorneys commonly use standard contracts that were previously drafted for other clients, they research form books for standard contracts, and they search the Internet for contracts that have been drafted by other attorneys for clients with similar transactions.<sup>55</sup> This “precedent-based

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<sup>54</sup> *Id.*

<sup>55</sup> See ESPENSCHIED, *supra* note 8, at 24 (recommends developing a “portfolio of ‘standard’ forms for transactions that are similar in nature”); Scott J. Burnham, Larry A. DiMatteo, Kenneth A. Adams & J. Lyn Entrikin Goering, *Transactional Skills Training: Contract Drafting – Beyond The Basics*, 10 TRANSACTIONS: TENN. J. BUS. L. 253, 263

“drafting” approach to drafting a new contract for a new client makes sense. Not only does modifying a previously drafted contract require significantly less time than drafting a contract from scratch, but a standard contract available over the Internet might be generally accepted within the industry.<sup>56</sup>

However, attorneys should not use standard or form contracts to memorialize different transactions. In fact, it may be unwise to use standard or form contracts to memorialize transactions even if the transactions are somewhat similar or involve the same subject matter. The previously drafted contract might involve significantly different deal points, it will only be as good as the initial drafter, it could be outdated, and it might have been written to favor the party on the other side of the transaction.<sup>57</sup>

If a standard or form contract is chosen as a starting point, it should not be used blindly.<sup>58</sup> There is no reason to include provisions from a standard or form contract in a different and subsequently drafted contract if the provisions do not apply to the transaction or they will never be triggered. For example, a contract used to purchase shovels does not need to include a “work for hire” provision. Similarly, a contract used to license software does not need to include a provision requiring the licensee to purchase insurance coverage to protect the licensor from any liability arising from the licensee’s use of the software.

Finally, attorneys should also recognize that contracts and pleadings are two very different documents. The “style of the case” from a pleading should never be substituted for the introductory paragraph and recitals in a contract.<sup>59</sup>

### C. Practical Tip #3: Be Clear and Precise

“A well-written contract provision is one that provides no traction for either party or [its] counsel to argue that something else was intended.”<sup>60</sup> Well-written provisions contain no ambiguities and clearly articulate the parties’ original intent. A well-written contract includes what’s necessary to ensure complete performance by each party, and “[u]sing plain, modern English. . .will ensure that the parties’ intent is accurately expressed.”<sup>61</sup>

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(2009) (previously drafted contracts are often used as templates); Schiess, *supra* note 5, at 46 (attorneys should use standard forms); Risdon-1999, *supra* note 52, at 12 (experienced contract drafters should have sample contracts); Martin, *supra* note 53, at 56 (recommends asking the client for sample contracts, checking form books, and buying forms on CD ROM); *Nine Tips to Create Better Contracts*, <http://allbusiness.com/legal/contracts-agreements/1532-1.html> (last visited Aug. 8, 2014) (sample forms can alert the attorney to issues and can provide “strong, standard language” for the contract, but should be used only as a starting point).

<sup>56</sup> See ESPENSCHIED, *supra* note 8, at 24-25 (borrowing language from prior contracts simplifies the drafting process); Burnham, *supra* note 55, at 263 (the industry might have developed a model contract and starting from a model contract is more cost effective).

<sup>57</sup> See *id.*

<sup>58</sup> See Schiess, *supra* note 5, at 46.

<sup>59</sup> See Gisela M. Munoz, *Writing Tips for the Transactional Attorney*, 21 PRAC. REAL EST. LAW. 33, 33-35 (2005). See also James W. Martin, *50 Tips for Writing the Contract That Stays Out of Court (with Forms)*, 14 PRAC. REAL EST. LAW. 55, 57 (1998).

<sup>60</sup> FOX, *supra* note 44, at 67.

<sup>61</sup> Gisela M. Munoz, *Writing Tips for the Transactional Attorney*, 21 PRAC. REAL EST. LAW. 33, 36 (2005). See

As important as it is to draft contracts so that they clearly communicate the parties' original intent, it is just as critical to be aware of statutory requirements (and prohibitions) that might make the contract unenforceable if it contains such provisions. For example, in a Texas construction contract, a contractor cannot indemnify an architect from liability for the architect's own negligence.<sup>62</sup> In addition, a provision that establishes a limitations period of shorter than two years to file a suit on a contract is void in Texas.<sup>63</sup>

Part of being clear and precise requires shorter, not longer sentences.<sup>64</sup> William Faulkner's writings should not be used as templates for drafting contract language. The shorter the sentences, the more clear and precise they will be, especially if they are structured logically – with subjects and verbs together and at the beginning of the sentence.<sup>65</sup> Further, using active voice (rather than passive voice) to draft provisions will facilitate using the correct contract concept to convey the parties' intent.<sup>66</sup> Finally, deleting unnecessary (or archaic) words will streamline the contract and make it easier to understand.<sup>67</sup>

#### **D. Practical Tip #4: Read Every Word of a Contract Before the Client Signs It**

Attorneys have a tendency to be less careful checking successive drafts of a contract than they are when they first review it.<sup>68</sup> Without casting aspersions, a transaction attorney "must concentrate on reading a final draft as if [he/she] were reading the document for the first time."<sup>69</sup> Given the ease of creating and reviewing contracts electronically, it's important to print and review a hard copy of the contract even if it's been reviewed numerous times on the computer; "[the attorney] will find substantive errors and glitches when reviewing a hard copy that [he/she] will not find looking at the contract on a computer screen."<sup>70</sup> "There is no use in blaming mistakes on the secretary or typist. It is up to the draftsman to correct mistakes."<sup>71</sup>

One contract this author recently reviewed contained a provision (in the Covenants of the

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*also* ESPENSCHIED, *supra* note 8, at 109-113 (presents pros and cons of using plain English); STARK, *supra* note 2, at 201 (defines plain English).

<sup>62</sup> TEX. GOV'T CODE ANN. Tit.10, subtit. F, § 2252.902(b)(2) (2005).

<sup>63</sup> TEX. CIV. PRAC. & REM. CODE § 16.070 (1999).

<sup>64</sup> *See* ESPENSCHIED, *supra* note 8, at 143-44 (recommends using short sentences); Martin, *supra* note 53, at 58 (short sentences are easier to understand); Johnny Miller, *60 Practical Contract-Drafting Tips*, <http://www.contracts.com/id29.html> (last visited Aug. 8, 2014) (sentences should be no more than 25 words long).

<sup>65</sup> *See* STARK, *supra* note 2, at 287-90.

<sup>66</sup> *See id.* at 117-18 (discussing active versus passive voice); Duke A. McDonald, *The Ten Worst Faults in Drafting Contracts*, 63 J. MO. B. 173, 173 (2007) (avoid writing in passive voice); Martin, *supra* note 53, at 58 (recommends active tense); Miller, *supra* note 64.

<sup>67</sup> FOX, *supra* note 44, at 73-77. Difficult to keep things simple – advances in technology mean transactions are done "faster." *Id.* at 74. Transactions are increasingly more complex. *Id.* Identifying creative solutions may create problems. *Id. See also* STARK, *supra* note 2, at 256-60 (lists common archaic words and phrases); McDonald, *supra* note 66, at 173 (avoid using words "that were once the 'coin of the realm' but have no modern currency").

<sup>68</sup> *See* Segall, *supra* note 12, at 752.

<sup>69</sup> *Id.*

<sup>70</sup> STARK, *supra* note 2, at 419.

<sup>71</sup> Segall, *supra* note 12, at 752.

Client section) that created an employer-employee relationship between the author's client and the other party. Only by reading the entire contract (including the Miscellaneous Provisions section), did this author discover that the contract also contained an Independent Contractors provision – disclaiming any employer-employer relationship between the parties. The other party conceded that it had simply cut and pasted the Miscellaneous Provisions section from a contract between its client and an independent contractor that the other party's client had engaged – but had failed to read the entire Miscellaneous Provisions section again before presenting the author's client with the contract.

A different Miscellaneous Provisions error in a contract, this one between a hospital and a vendor, could have resulted in excessive liability on the part of the hospital had the error not been identified and corrected before the contract was executed. In this particular Vendor Supply Agreement, the vendor had buried an indemnification provision in the middle of the Miscellaneous Provisions section, and the hospital's attorney failed to notice the provision until right before the Agreement was presented to the hospital for signature.

Finally, in an employment contract, counsel for a group of employees drafted detailed provisions describing how bonuses were to be determined and when they were to be paid using a presentation the employer had made to the group of employees during the initial discussions as the basis for her language. The draft was circulated to all employees in the group. Several of the employees in the group made recommendations and suggestions, all of which counsel for the group of employees incorporated into the draft contract. A redline version of the contract (clearly delineating the additions) was presented to the employer, but the changes to the bonus compensation were not addressed until just before the employer printed copies for each member of the group to execute. Only then did the employer recognize the level of detail that had been provided and revise the language.

#### **E. Practical Tip #5: “Murphy’s Law”<sup>72</sup> Always Applies**

When drafting contracts, attorneys should always keep the worst case scenario in mind so that the final contract addresses virtually every possible situation that might arise – even if it never does. By incorporating all available remedies into the contract to prevent (as much as possible) his/her client's falling victim to Murphy's Law after the conclusion of the attorney's representation, the attorney can help to ensure that the client is as protected as possible.

However, attorneys should not necessarily provide their client with a detailed explanation of everything that might go wrong in or with a particular transaction. Instead, attorneys should remember what objectives their clients have established and present the information in a manner designed to educate – not scare – their clients. Doing so will enable the attorney to successfully manage his/her client's expectations, and to respond promptly to the client's inquiries<sup>73</sup> even

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<sup>72</sup> Murphy's Law provides, “If anything can go wrong, it will.” *Murphy's Law Site*, <http://www.murphys-laws.com/murphy/murphy-true.html> (last visited Aug. 8, 2014). Murphy's Law originated at Edwards Air Force Base in 1949 when Captain Edward A. Murphy, an engineer working on a project to determine the amount of sudden deceleration a person could stand in a crash, got mad at a technician who had wired a transducer needed in the project incorrectly. *Id.* The project manager in charge of the project kept a list of “laws,” and added Murphy's comment about the technician to that list, calling it “Murphy's Law.” *Id.*

<sup>73</sup> TEX. DISCIPLINARY RULES PROF'L CONDUCT R. 1.03.

when (or if) it is personally inconvenient for the attorney to do so.<sup>74</sup>

## V. CONCLUSION

A transactional attorney must do more than simply draft clear and unambiguous contracts to be successful.<sup>75</sup> He/She must understand every transaction from the client's perspective, at least to the extent that he/she recognizes what goals and objectives the client wants to achieve and what risks the client wants to avoid.<sup>76</sup> A successful transactional attorney will also add value to the deal<sup>77</sup> and "act with competence, commitment and dedication to the interest of the client . . . upon the client's behalf."<sup>78</sup>

The successful transactional attorney will also be sensitive to and understand what makes drafting contracts different from drafting other types of legal documents and will anticipate and avoid some of the more common ethical issues that might arise during the contract process. He/She will be an integral part of the contract process but will recognize and use the contributions others within the client's organization can bring to the table. As a contract drafter, the successful transactional attorney will have numerous form contracts on which he/she can rely, but will use them only with caution and only as a starting point to create unique contracts for each client and transaction. In each contract, the successful transactional attorney will draft language that is clear, precise, and tailored to meet the client's expressed objectives. And regardless of the number of times the attorney has commented on or reviewed a draft contract, he/she will read every draft or revision of the contract presented during the contract process as if it was for the first time. Finally, and remembering that Murphy's Law always applies, the successful transactional attorney will anticipate future possibilities and probabilities that could arise and include remedies and language the client can apply in the remote possibility that the business deal goes awry.

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<sup>74</sup> TEX. DISCIPLINARY RULES PROF'L CONDUCT R. 1.01(b) cmt. 6.

<sup>75</sup> STARK, *supra* note 2, at 369.

<sup>76</sup> *Id.*

<sup>77</sup> *Id.*

<sup>78</sup> TEX. DISCIPLINARY RULES PROF'L CONDUCT R. 1.01(b) cmt. 6.

# ON FEDERAL PREEMPTION OF STATE SECURITIES REGULATION AND THE FUTURE OF CAPITAL FORMATION FOR SMALL BUSINESS – THE DAWN OF A NEW ERA AT THE SEC

Samuel S. Guzik\*

December 18, 2013 may well mark a historic turning point in the ability of a small business to effectively access capital in the private and public markets under the federal securities regulatory framework. On that day, the Commissioners of the U.S. Securities and Exchange Commission (SEC) met in open session and unanimously authorized the issuance of proposed rules<sup>1</sup> intended to implement Title IV of the Jumpstart Our Business Startups Act of 2012 (the “JOBS Act”)—a provision widely labeled as “Regulation A+,” whose implementation is dependent upon SEC rulemaking.<sup>2</sup> Title IV, entitled “*Small Company Capital Formation*,” was intended by Congress to expand the use of Regulation A—a little used exemption from full blown SEC registration of securities which has been around for more than 20 years—by increasing the dollar ceiling from \$5 million to \$50 million.<sup>3</sup> Both the scope and breadth of the SEC’s proposed rules, and the areas in which the SEC expressly seeks public comment, appear to represent an opening salvo by the SEC. As a result, a fierce and long overdue battle between the Commission and state regulators will ensue, in which the SEC is determined to reduce the burden of state regulation on capital formation—a burden falling disproportionately on small businesses—while state regulators seek to preserve their autonomy to review securities offerings at the state level.

Specifically, Regulation A (in theory) has allowed private companies to raise capital, up to \$5 million, through an abbreviated “mini-registration” process with the SEC. This allows public solicitation of both accredited and non-accredited investors and the ability to issue shares which are freely tradable. Regulation A has, as its advantages, such features as: (i) reduced disclosures to investors relative to a full SEC registration, including the ability to utilize “reviewed” financial statements instead of audited financial statements; (ii) limited SEC review; (iii) the ability to “test the waters” with investors prior to incurring significant upfront costs such as filing an offering memorandum with the SEC; (iv) the ability of an investor to receive free trading shares upon their issuance; and (v) the absence of post-offering reporting requirements, unless and until a company meets the threshold reporting requirements applicable to all companies under the Securities Exchange Act of 1934.<sup>4</sup>

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<sup>1</sup> Sec. and Exch. Comm’n Release No. 33-9497 (Dec. 18, 2013), <https://www.sec.gov/rules/proposed/2013/33-9497.pdf>.

<sup>2</sup> H.R. Con. Res. 3606, 112th Cong. (2012) (enacted).

<sup>3</sup> H.R. 1070, 112th Cong. (2012) (enacted).

<sup>4</sup> See, e.g., Craig M. Lewis, U.S. SEC. AND EXCH. COMM’N, MIT Sloan Sch. of Mgmt.’s Ctr. for Fin. and Policy’s Distinguished Speaker Series (Apr. 15, 2014), <http://www.sec.gov/News/Speech/Detail/Speech/1370541497283#.U-qdMfldWfY>.

Regulation A's relative non-use as a capital raising tool has been widely attributed to two factors—the offering costs relative to the dollar amounts being raised and the necessity of complying with blue sky laws in each state where the offering is conducted.<sup>5</sup> Some have argued that the \$5 million limit on Regulation A is too low to provide an effective means of raising capital, after factoring in all of its attendant costs and burdens, including outsized disclosure costs. Others, including myself, have argued that the biggest culprit in the dysfunctionality of Regulation A is the need for a company to navigate a labyrinth of state blue sky laws, despite SEC review—adding both expense and delay. In some states, qualifying a federally reviewed and approved Regulation A offering was not even an option, under a blue sky regimen commonly referred to as “merit review.”

Unlike the SEC registration process, whose talisman is full and fair disclosure to the investor, and is agnostic as to the quality of the investment, many states, in addition to a separate review process, have effectively closed the door to what they deem as investments too risky for the average retail investor. Often this has precluded entire industries, such as biotechnology, from utilizing Regulation A, as they typically generate little or no revenue in their early years and do not expect to be profitable under any scenario for at least three to five years. Other high tech development stage companies, with oversized valuations relative to benchmarks, such as tangible book value or earnings per share, have been similarly excluded under some state blue sky laws. And even for eligible companies who are otherwise able to reach out to prospective investors in more than one state, the prospect of qualifying an offering through a multi-state review is simply too daunting in terms of both time and money.

Title IV of the JOBS Act was intended to solve some of the perceived limitations of Regulation A. In solving these problems, Congress provided an annual dollar limit for Regulation A+ offerings of \$50 million—subject to ongoing periodic reporting and conditions not required in financial statements audited under Regulation A. Such requirements are not unreasonable for companies seeking to issue publicly tradable securities where higher dollar amounts are being raised. And to eliminate the necessity of costly entanglement in the web of state blue sky regulation, Congress exempted two categories of securities issued under the *new* Regulation A+ (now Section 3(b)(2) of the Securities Act of 1933): (1) offerings limited to “qualified purchasers” and (2) securities offered and sold on a national securities exchange. Implementation of Regulation A+, including the definition of what a “qualified purchaser” is, was left to rulemaking by the SEC. However, Congress left untouched the pre-Title IV Regulation A, limited to \$5 million (formerly Section 3(b) of the Securities Act of 1933, now re-designated Section 3(b)(1) of the Securities Act). This had the effect of appearing indifferent to easing capital formation for small businesses seeking to raise up to \$5 million—many of whom could not be expected to meet the heightened audit and ongoing disclosure requirements required by new Regulation A+.

On December 18, 2013, 20 months after the enactment of the JOBS Act, the SEC seemingly blew the doors off of Regulation A+, giving much needed hope to small businesses seeking to raise capital to develop and expand their businesses. Notwithstanding the backlog of still unissued (and long overdue) regulations dictated by the Dodd-Frank Act, and the failure of the JOBS Act to provide any SEC rulemaking deadline for Title IV, the Commission issued a 387 page release

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<sup>5</sup> See, e.g., GAO Report to Congressional Committees, “*Factors That May Affect Trends in Regulation A Offerings*,” (July 2012), <https://www.sec.gov/rules/proposed/2013/33-9497.pdf>.

which was stunning in both its reach and breadth.<sup>6</sup> The Release proposed to exempt *all* Regulation A+ offerings over \$5 million from state blue sky review. The Release immediately prompted a strong rebuke by William F. Galvin, Secretary of the Commonwealth of Massachusetts, in a formal comment letter submitted to the SEC on the same day the Release was issued.<sup>7</sup> The comment letter strongly opposed the proposed reach of the SEC in the Release's proposed rule, which would exempt virtually all securities issued under Regulation A+ from state blue sky regulation of offerings over \$5 million:

We are dismayed and shocked to see that the Commission's Regulation A-Plus' proposal includes provisions that preempt the ability of the states to require registration of these offerings and to review them. The states have tackled preemption battles on many fronts, but *never before have we found ourselves battling our federal counterpart*. Shame on the S.E.C. for this anti-investor proposal. This is a step that puts small retail investors unacceptably at risk. We urge the Commission to remove these provisions from the rule. [emphasis added; footnote omitted]<sup>8</sup>

The hook that the SEC used to exempt Regulation A+ offerings over \$5 million from state review was to deem all securities sold in a Regulation A+ offering over \$5 million to be sold to qualified purchasers. From a legal point of view, Mr. Galvin argued that by providing an exemption from state registration for all Regulation A+ offerings over \$5 million, this contravened the intent of Congress to have "qualified purchasers" defined on the basis of their sophistication and financial wherewithal, and not simply the type of transaction being conducted.

Perhaps even more significant than proposing to pre-empt Regulation A+ offerings over \$5 million from state review, the December 18 SEC Release also solicited comments on the scope of the existing, pre-JOBS Act Regulation A (*i.e.* Regulation A offerings for \$5 million and under). The Release proposed to denominate two classes of Regulation A+ offerings: Tier I—\$5 million and under; and Tier II—\$5 million to \$50 million. Though not yet proposing any new rules in this regard, the Release solicited public comments on Tier I Offerings (\$5 million and under), *including whether Tier I offerings should be exempt from state blue sky registration and review*. This came as a surprise to this writer, because Title IV, as enacted by Congress, left the pre-JOBS Act Regulation A (now designated Section 3(b)(1) intact and unscathed) continuing to leave small businesses as the neglected step child of the federal post-JOBS Act securities regulation framework.

Without jumping into the fray as to whether the SEC currently has the statutory authority to exempt all Regulation A+ offerings over \$5 million from state blue sky regulation (by deeming every investor a qualified purchaser), suffice it to say that, from the point of view of the Title IV requirements, the proposed rules have pushed the edge of the envelope—if not outside the envelope itself—by designating *every* investor a qualified purchaser. The SEC's legal position is not without its supporters, notable among them being Rutheford B. Campbell, Jr., law professor at the University of Kentucky. Professor Campbell has publicly argued for the very position the SEC

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<sup>6</sup> Sec. and Exch. Comm'n Release No. 33-9497 (Dec. 18, 2013), <https://www.sec.gov/rules/proposed/2013/33-9497.pdf>.

<sup>7</sup> Letter from William F. Galvin, Secretary of the Commonwealth, Commonwealth of Massachusetts, to the SEC dated December 18, 2013, <https://www.sec.gov/comments/s7-11-13/s71113-1.pdf>.

<sup>8</sup> *Id.* at 1.

has taken in the Release, both in formal comments to the SEC and in published articles.<sup>9</sup> In his view, the SEC not only has the authority to exempt all Regulation A+ offerings, but it should exercise its discretion in the broad manner adopted by the SEC in the proposed rule—for offerings above and below \$5 million.

Professor Campbell has summed up the crux of the dilemma on more than one occasion. Notably, in one article Professor Campbell stated:

Regrettably, history shows an unwillingness on the part of the Commission to act in regard to expanding preemption of state authority over registrations. In both the legislations leading to the NSMIA [National Securities Markets Improvement Act of 1996] and the Dodd-Frank Act, the Commission failed to advocate for preemption.<sup>10</sup>

According to Professor Campbell, the victims of the SEC's tepid approach to curtailing state regulation—small businesses.

It seems that, to the dismay of NASAA<sup>11</sup> and Secretary Galvin, Professor Campbell drew a Royal Flush on December 18, when the SEC adopted the position of Professor Campbell, lock, stock and barrel. It remains to be seen, however, whether his luck (and the luck of small business) will hold out when the comment period ends and the dust settles on final rules.

In the face of strong opposition from state regulators such as Massachusetts Secretary of State Galvin and a host of consumer protection groups, I expect that there will be dark legal clouds looming over the SEC's position. It may well be that the proposed regulatory action by the SEC may turn out to be too little too late. Ultimately, it may take another act of Congress to settle the ensuing debate—something that might have been avoidable if the SEC joined the conversation at the Congressional table in 2012 with a strong hand and a strong voice—advocating the need for preemption of state securities regulation of Regulation A and Regulation A+ offerings. Though late to the party, it appears that the SEC may now be prepared to take its case to Congress, if necessary.

Indeed, it seems that, at long last, the battle that has been assiduously avoided by the SEC in recent decades, federal pre-emption of offerings involving non-accredited investors from state blue sky review, has finally begun. The decade's long posture of the SEC avoiding confrontation with state regulators and their national mouthpiece, the North American Securities Administrators Association (NASAA), has apparently given way to a long overdue demonstration of political and

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<sup>9</sup> See Letter from Rutherford B. Campbell, Jr., William L. Matthews Professor of Law, to the SEC dated November 13, 2012, <http://www.sec.gov/comments/jobs-title-iv/jobtitleiv-18.pdf> (last visited Aug. 13, 2014); see also Letter from Rutherford B. Campbell, Jr., William L. Matthews Professor of Law, to the SEC dated January 30, 2012, <http://www.sec.gov/rules/proposed/s72301/campbel1.htm> (last visited Aug. 13, 2014); see also Rutherford B. Campbell, Jr., *The Wreck of Regulation D: The Unintended (and Bad) Outcomes for the SEC's Crown Jewel Exemptions*, 66 BUS. LAW 919 (Aug. 2011), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1971200](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1971200).

<sup>10</sup> Campbell, *The Wreck of Regulation D: The Unintended (and Bad) Outcomes for the SEC's Crown Jewel Exemptions*, *supra* note 6, at 941.

<sup>11</sup> See, e.g., Letter from A. Heath Abshire, President, North American Securities Administrators Association, Inc., to the SEC dated April 10, 2013, <http://www.sec.gov/comments/jobs-title-iv/jobtitleiv-25.pdf> (last visited June 18, 2014).

institutional will by the SEC that seeks to forcefully advocate for a rational federal regulatory scheme, which would pre-empt the ability of states to impose review of smaller offerings to non-accredited investors. It appears that the SEC has come to the realization that passivity on its part, even in the face of strong opposition from state regulators or consumer advocate groups, will not properly serve the interests of small business capital formation.

The question is why the SEC is now seemingly taking a proactive approach to opening up new avenues of capital formation for small business—putting it on a collision course with many state regulators, if not NASAA itself, and what this may portend, both in terms of future SEC rulemaking and Congressional action in the form of “JOBS Act 2.x.” Though post-JOBS Act Congressional oversight may have played a role, there appears to be other operative factors—stemming in large part from the SEC’s failure to come to the table in Congress when the JOBS Act was being formulated. I believe the answer is largely explained by two factors: the changing of the guard at the SEC Chair level in 2013, and the fallout resulting from Congressional action in the form of the JOBS Act with the SEC largely absent from the legislative process.

## I. WHAT IS NEW AND WHY?

2012 was marked by more than just the enactment of the JOBS Act. The year was also marked by a vacuum in decisive leadership at the SEC in spearheading necessary legislative and regulatory reforms. Indeed, according to the SEC’s own website, the Commission was entirely absent from crafting the federal legislation now known as the JOBS Act.<sup>12</sup> The JOBS Act, once enacted, was initially met with deafening silence from the SEC as to key provisions intended to “Jumpstart Our Business Startups.” By way of example, no one needs reminding of the 90 day Congressional deadline to enact Title II rules (public solicitation in private placements *a la* new Regulation D Rule 506(c)) and the 270 day deadline for the SEC to enact rules implementing the crowdfunding provisions of Title III—deadlines which unapologetically came and went.

But something seems to have changed at the SEC in 2013—the most significant catalyst being, in my opinion, the changing of the guard at the SEC Chair level, from Mary Jo Shapiro to Mary Jo White. The SEC, having stood on the sidelines as the JOBS Act legislation meandered through Congress, found itself as the not so proud owner of a regulatory scheme which in many respects is both incongruous and dysfunctional—especially in terms of meeting the needs of small businesses—sector widely viewed as the engine of job growth and economic prosperity. Indeed, far from being the “holistic” overhaul of securities regulation envisioned by at least one of the SEC commissioners,<sup>13</sup> SEC inaction while the JOBS Act was cobbled together by Congress left the Commission with a modified regulatory scheme that is “hole”-“istic”—not holistic. One does

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<sup>12</sup> The only Congressional testimony reflected on the SEC’s website ([www.sec.gov](http://www.sec.gov)) relating to the JOBS Act, was on December 1, 2011, testimony on “Spurring Job Growth Through Capital Formation While Protecting Investors,” before the Committee on Banking, Housing and Urban Affairs, Meredith B. Cross, Director, Division of Corporation Finance, and Lona Nallengara, Deputy Director, Division of Corporation Finance, <http://www.sec.gov/news/testimony/2011/ts12011mbc.htm> (last visited June 18, 2014). However, the testimony, while addressing many of the issues ultimately addressed by the JOBS Act, took no position on these issues.

<sup>13</sup> See, e.g., Remarks at FIA Futures and Options Expo, Commissioner Daniel M. Gallagher, U.S. SEC. AND EXCH. COMM’N (Nov. 6, 2013), <https://www.sec.gov/servlet/Satellite/News/Speech/Detail/Speech/1370540289361#.UscADrTl-70>.

not need to scratch far beneath the surface of the JOBS Act and existing SEC regulations to see the incongruous mess that Congress has left to the SEC to either live with—or clean up. Judging by the approach taken by the SEC in the December 18 Release, it appears that the SEC is poised to clean up at least part of the mess—and take on the strong and vocal opposition at the state level—after years of avoiding this fight.

As Commissioner Gallagher recently remarked, though a careful review of the entire regulatory scheme may be a logical precedent for change in securities regulation in many instances<sup>14</sup>, a pragmatic approach of addressing the regulatory scheme on a piecemeal basis is the likely path of least resistance at the Commission level. Currently on the front burner at the SEC awaiting implementation of final rules are two sectors, both aimed at “small businesses,” Title III Crowdfunding and Title IV’s Regulation A+. An examination of these areas, post-JOBS Act, provides some clues as to the dilemma the Commission faces following action by Congress in the form of the 2012 JOBS Act.

## II. TITLE III (CROWDFUNDING) VS. REGULATION A

### A. Is Title III Crowdfunding Crowded With Too Many Costs?

Let’s start with the very bottom of the food chain—JOBS Act Title III crowdfunding—a financing model widely dismissed by the securities bar and others as both ill advised and unworkable. Title III attempted to create a new market structure whereby unlimited numbers of unsophisticated investors could invest in high-risk companies through an intermediary on the Internet. The statute limits the amount that an investor can put at risk, and a company may not raise more than \$1 million in any 12-month period using this exemption. Though the company must incur the expense of preparing a detailed disclosure document for investors, there is no SEC or state blue sky review. The statute also requires that the issuer conduct investor solicitations on an Internet portal run by an SEC and FINRA licensed broker-dealer or funding portal.

The SEC, under its prior Chairman, turned its back on the concept of crowdfunding for profit as being inconsistent with the Commission’s obligation to protect investors. Thus, it ought not to come as a surprise that the end product of Title III clashes with policies embedded in long standing SEC regulations governing other exemptions for higher dollar amounts, most notably Regulation A.

Title III mandates that companies raising between \$500,000 and \$1,000,000 provide investors with audited financial statements. This requirement adds a significant expense to startups and small, emerging companies. It is not clear what audited financial statements add to the investor information mix, relative to the cost of the audit itself—as opposed to “reviewed” financial statements—especially for companies with little or no revenue. The cost of an audit, when factored in with other Title III costs that must be borne by the issuer, will likely make the cost of a Title III financing unattractive, if not prohibitive. Particularly since these costs must be incurred up front, before there are any assurances of a successful capital raise.

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<sup>14</sup> See Remarks at the Second Annual Institute for Corporate Counsel, Daniel M. Gallagher, U.S. SEC. AND EXCH. COMM’N (Dec. 6, 2013), <https://www.sec.gov/servlet/Satellite/News/Speech/Detail/Speech/1370540462287#.UscE-bTl-70>.

Moreover, the impact on a small business of providing audited financial statements, not to mention extensive non-financial disclosure, does not end when the offering is successfully completed. Congress also mandated that the price a company must pay for a successful offering is to file fairly extensive ongoing periodic reports—at least until the company either buys back the offered securities or goes out of business.

The picture is not much better for investment crowdfunding raised by small businesses that are under \$500,000. These require the same detailed non-financial disclosure as well as reviewed financial statements for offerings above \$100,000. Add to this up, front legal compliance costs and the cost of using an intermediary, and the excitement over the possibilities held out by investment crowdfunding quickly fades.

### **B. And What About Pre-JOBS Act (and Post-JOBS Act) Regulation A?**

Contrast Title III's requirements for audited financial statements for offerings over \$500,000, ongoing annual reports to investors, limitations on direct public solicitation, and one year of non-transferability of the crowdfunded securities—with requirements that are *absent* under the long standing Regulation A mini-registration for an offering of *up to \$5 million*. Most of the irony is summed up in an introductory paragraph on page 9 of the SEC's December 18 Reg. A+ Release, addressing what the SEC now proposes to label as Tier I Regulation A (\$5 million and under), an irony I am certain was not lost on the SEC's new Chair:

Regulation A permits issuers to communicate with potential investors, or “test the waters” for potential interest in the offering, *before* filing the offering statement. . . Regulation A offering circulars are required to contain issuer financial statements, but the financial statements are *not required to be audited* unless the issuer otherwise has audited financial statements available. Qualification of a Regulation A offering statement does not trigger reporting obligations under the Exchange Act [*or any other ongoing reporting obligations*]. A Regulation A offering is a public offering, *with no prohibition on general solicitation and general advertising. Securities sold under Regulation A are not “restricted securities” under the Securities Act and, therefore, are not subject to the limitations on resale* that apply to securities sold in private offerings. [emphasis added; footnotes omitted]<sup>15</sup>

To sum it up, Congresses' Title III crafted a framework for small, “bite-sized” companies which is not only laden with costs relative to the amounts being raised, but places far greater burdens on those small businesses at the bottom of the food chain (up to \$1 million). Parallel those provisions with a 20 year old exemption, like Regulation A, which allows capital raises up to five times greater than Title III crowdfunding.

Unfortunately, Congress did not *expressly* address the needs of small businesses seeking to raise up to \$5 million through a Regulation A type offering—an option which would allow an issuer to reach out to both accredited and non-accredited investors in a cost effective manner—by exempting these smaller offerings from state blue sky review. Nor, in my view, did it clearly and cogently address head on the need to exempt all Regulation A+ offerings, big or small, from burdensome state regulations—something the SEC now appears ready to push through.

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<sup>15</sup> Sec. and Exch. Comm'n Release No. 33-9497, *supra* note 6, at 9.

### III. TITLE IV REGULATION A+ – TIER I (REGULATION A) VERSUS TIER II OFFERINGS

The rules proposed by the SEC to implement Title IV's Regulation A+ created a two tier system: Tier I offerings up to \$5 million, and Tier II offerings up to \$50 million. As to the proposed Tier II rules, the SEC calls for registration statement type disclosure more onerous than current Regulation A, audited financial statements, and periodic disclosures to be filed with the SEC following completion of the offering. These burdens may well be appropriate for the higher dollar amounts between \$5 - \$50 million.

What is still missing from the equation is a viable alternative for small companies seeking to raise up to \$5 million. Something that would at the least require the SEC, through regulatory action, or Congress through further legislation, to deem securities sold in any Regulation A offering as "covered securities" exempt from state merit review and registration under Section 18 of the Securities Act. It appears from the SEC's call for comment on whether these small offerings should be immune from state blue sky review, that it understands the importance of filling an important gap in Title IV of the JOBS Act—expressly addressing the needs of small businesses seeking to raise up to \$5 million.

Some might say that answers for small business capital formation in the \$5 million and under space have already been provided—in the form of a new and improved Rule 506(c) under Regulation D (courtesy of Title II of the JOBS Act).<sup>16</sup> Rule 506 allows companies to raise an unlimited amount of capital from "accredited investors" in a private placement without any particular type of disclosure. The new Rule 506(c) allows companies to engage in general solicitation and advertising, so long as all of the investors are accredited and the company takes measures reasonably calculated to ensure that all investors are in fact accredited. Since 1996, when Congress adopted the National Securities Markets Improvement Act of 1996 (NSMIA), offerings under Rule 506 have been exempt from state blue sky review. However, a company that wishes to take money from non-accredited investors (what President Obama has referred to in his April 5, 2012 Rose Garden speech as "ordinary Americans")<sup>17</sup> still may not engage in any public solicitation (unlike Regulation A and Regulation A+), and is required to provide the same type of disclosure as is required in a SEC registered offering, including audited financial statements. Though these limitations may suffice for companies willing and able to limit their investor base to accredited investors, they do not suffice for companies who either need or desire to include "ordinary" investors, or require liquidity in order to effectively market their shares.

Thus, depending upon final rulemaking by the SEC, the net effect of the current regulatory scheme may very well be to require small companies to either pursue a capital raise greater than \$5 million—when such an offering is simply neither necessary or practical, limit their investor base to "accredited investors under Rule 506 (exempt from blue sky since 1996)," or navigate the maze of blue sky regulations which has proven to be a deterrent to its utility over the past 20 years. None of these options has worked particularly well for vast numbers of small businesses.

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<sup>16</sup> Sec. and Exch. Comm'n Release No. 33-9415, *supra* note 6.

<sup>17</sup> Press Release, Office of the Press Secretary, Remarks by President Barack Obama at the JOBS Act Bill Signing (Apr. 5, 2012).

A permanent solution to this problem may very well lie in the hands of Congress—who through further legislation could authorize the SEC to further modify Regulation A by making the issued securities “covered securities” under Section 18 of the Securities Act, thus freeing a company from the burden of complying with state blue sky regulations. If history is to be a guide, it is unlikely that this solution will come to fruition from the initiative of Congress absent strong advocacy on the part of the SEC —something lacking in 2012 under the tutelage of former Commissioner Shapiro (and her predecessors). However, the scope of the December 18 Release suggests that at least some at the Commission level, under the leadership of Chairman White, are able and willing to take on this task.

In the short term, the future of Regulation A (and A+) offerings may very well hinge upon the strength and volume of comments received in response to the SEC’s December 18 call for comment on exempting all Regulation A (and A+) offerings from state review, regardless of the dollar amount. But the *sine qua non* for change will be the political and institutional will of the SEC to take on the state securities regulators, who are well organized and very outspoken.

## IV. SOME HISTORY LESSONS

### A. Banned in Boston

Though the U.S. history of federal and state securities regulation has not been kind to small business, it does present some valuable lessons to help place the issue of state securities regulation in perspective, albeit with some ironies.

The year was 1980. The headline in the Wall Street Journal on December 12, 1980 read “*Massachusetts Bars Sale of Stock as Risky*.” It seems that the State of Massachusetts, in its zeal to protect investors, was one of a handful of states to bar “ordinary investors” from participating in what it viewed as a (too) hot IPO. Having raised the initial offering price to \$22.00 per share, a company about to complete its IPO was told by the State of Massachusetts that its offering did not meet its stringent blue sky standards. In its opinion, the offering price was too high relative to its earnings and book value. The result—the offering was withdrawn from the State of Massachusetts—and was only made available to retail investors in 27 states.

Today the stock trades at over \$500.00 per share. The name of the company was Apple Computer—whose market capitalization ultimately made it the most highly valued public company in the world.

Apparently, not too much has changed in Massachusetts since 1980, at least judging by Secretary of State Galvin’s letter to the SEC of December 18, 2013.

Ultimately, Congress passed legislation which preempted state blue sky review for offerings that involved companies listed on a national securities exchange. Unfortunately, most small companies continue to be left out in the cold, unable to make the leap to a national exchange without some seasoning and additional capital.

### **B. The State of Kansas as the Thought Leader in State Blue Sky Regulation**

Ironically, the first state in the Union to implement merit review was Kansas in 1911—to protect ordinary investors from falling victim to slick salesmen travelling the back roads of Kansas selling “blue sky” and snake oil to would be investors. A full century later, in 2011, Kansas became the first state to implement its own brand of investment crowdfunding for investment activities within its borders. It did so through regulatory action by its securities commissioner, without the necessity of state legislation.

Seems that the state securities regulators in the large majority of the other 50 states never got the memo.

### **C. Looking Ahead**

2013 was the year that the deck was reshuffled at the Commission level at the SEC. 2014 may be the year when the deck is reshuffled in the upcoming Congressional elections. With strong, decisive leadership at the SEC, and the appropriate voices speaking out on behalf of small business, real change in the ability of small business to raise capital from the public may finally be at hand.

2014 may very well see the genesis of what might be called “CrowdFunding Plus”—a modified Regulation A exemption which will free Tier I offerings (under \$5 million) from the entanglement of the current web of blue sky regulation. The modified regulation will be without more burdensome disclosure obligations, and the implementation of Tier II offerings, exempt from state blue sky review. And as part of what appears to be a long overdue shift in focus by the SEC from the interests of Wall Street to small business, it would not be surprising if this proactivity on the part of the SEC spills over to Title III crowdfunding—at least to engage Congress to correct some glaring incongruities.

If the SEC successfully continues down the path of pre-emption of state regulation, there will only be winners in this battle—and no losers. With a stronger economy will come a more robust tax base on the state and local level—resulting in more than ample resources for state regulators to put more “cops on the beat” to protect the investing public.

# TEXAS LIMITED LIABILITY COMPANIES: RESCISSION OF MANAGEMENT AGREEMENT; FAIR MARKET VALUE OF A WITHDRAWING MEMBER'S INTEREST; JOINT AND SEVERAL LIABILITY OF MEMBERS WITH THE LLC

By Jerel W. Ehlert II\*

*Kennebrew v. Harris*, 425 S.W.3d 588 (Tex. App.—Houston [14th Dist.] 2014, pet. denied)

## *Case Summary*

A withdrawing member, Michael Harris, of a Texas Limited Liability Company, Elite Protective Services, LLC, sued the company and remaining member, Charles Kennebrew, Sr., for the value of his membership interest in the company and to recover funds expended on the company's behalf as allowed in a Management Agreement.<sup>1</sup> At a bench trial, the court (i) rescinded the Management Agreement, (ii) ordered the return of Harris's capital contribution, (iii) found there was an oral loan agreement between the withdrawing member (Harris), the company, and Kennebrew, (iv) determined the company and Kennebrew breached that agreement by not repaying funds Harris had expended on behalf of the company, and (v) awarded damages and attorney's fees against Kennebrew and the company jointly and severally.<sup>2</sup> All parties appealed.<sup>3</sup>

## *Holding*

The Court of Appeals held:

- There was no evidence of an oral loan agreement;<sup>4</sup>
- Rescission of the Management Agreement was not available as a remedy;<sup>5</sup>
- Failure of the withdrawing member to register under a state statute, even if required under the Management Agreement, did not render the agreement unenforceable;<sup>6</sup>
- A member of a limited liability company, permitted to withdraw under the company agreement, is entitled to the fair market value of that member's interest in the company;<sup>7</sup>
- Remaining member was not jointly and severally liable with the company for the

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<sup>1</sup> *Kennebrew v. Harris*, 425 S.W.3d 588, 592-93 (Tex. App.—Houston [14th Dist.] 2014, pet. denied).

<sup>2</sup> *Id.* at 593.

<sup>3</sup> *Id.*

<sup>4</sup> *Id.* at 594-95.

<sup>5</sup> *Id.* at 595-96.

<sup>6</sup> *Id.* at 597-98.

<sup>7</sup> *Id.* at 598 and n.2.

judgment amount.<sup>8</sup>

### ***Rescission of the Management Agreement***

Rescission, short for rescission and restitution,<sup>9</sup> is an equitable remedy available where monetary damages alone will not suffice.<sup>10</sup> The party seeking rescission must prevail on a cause of action for which that is a remedy,<sup>11</sup> and the company did not prevail on any such cause of action against the withdrawing member.<sup>12</sup>

The LLC claimed the withdrawing member breached the Management Agreement by failing to register with a state agency while part of the company, as the agreement allegedly required, thus the Management Agreement never became effective, making rescission appropriate.<sup>13</sup> In Texas where the legislature supplies criminal or civil penalties sufficient to compel obedience with a mandatory statute, failure to comply does not render the contract void or voidable.<sup>14</sup> Failure to register under the applicable statute was punishable as a misdemeanor criminal violation and by a civil fine, which the court reasoned were sufficient to deter violations. Therefore, failure of the withdrawing member to comply with such a provision in the Management Agreement would not render the contract unenforceable.<sup>15</sup>

The party requesting rescission must comply with common law preconditions.<sup>16</sup> The party must first, give timely notice that the contract is being rescinded, and second, return or offer to return the property and the value of any benefit derived from its possession.<sup>17</sup> Failure to comply with the preconditions for rescission by keeping the property precludes availability of the remedy to that party.<sup>18</sup>

The company did not give notice to the withdrawing member and kept the withdrawing member's property. Even if the company had proved grounds for rescission, it would still be unavailable for failure to act like it was rescinding the Management Agreement by meeting the preconditions.<sup>19</sup>

### ***Fair Market Value***

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<sup>8</sup> *Id.* at 600-01.

<sup>9</sup> *Id.* at 595 (citing *Cruz v. Andrews Restoration, Inc.*, 364 S.W.3d 817, 825 (Tex. 2012) (quoting RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 54 cmt. a (2011))).

<sup>10</sup> *Id.* (citing *City of The Colony v. N. Tex. Mun. Water Dist.*, 272 S.W.3d 699, 732 (Tex. App.—Fort Worth 2008, pet. dism'd)).

<sup>11</sup> *Id.* at 596.

<sup>12</sup> *Kennebrew*, 425 S.W.3d at 596.

<sup>13</sup> *Id.* at 597.

<sup>14</sup> *Id.* at 597 (citing *New Bos. Gen. Hosp., Inc. v. Tex. Workforce Comm'n*, 47 S.W.3d 34, 40 (Tex. App.—Texarkana 2001, no pet.) (op. on reh'g)).

<sup>15</sup> *Id.* at 597-98.

<sup>16</sup> *Id.* at 596.

<sup>17</sup> *Id.* (citing *Cruz*, 364 S.W.3d at 824).

<sup>18</sup> *Id.*; see *Carrow v. Bayliner Marine Corp.*, 781 S.W.2d 691, 696 (Tex. App.—Austin 1989, no writ)).

<sup>19</sup> *Id.* at 596.

Members in a Texas Limited Liability Company do not have a statutory right of withdrawal.<sup>20</sup> In the case before the court, however, both the Company Agreement and the Management Agreement, allowed members to withdraw from the company.<sup>21</sup>

Having the contractual right of withdrawal, the member gave notice to the company and the remaining member.<sup>22</sup> The notice was acknowledged in a timely manner.<sup>23</sup> Having exercised a valid withdrawal, the member was entitled by statute to the fair market value of his membership interest in the company.<sup>24</sup>

The trial court found, and both parties agreed, that owners' equity was the value of all the assets the company owned, less all the liabilities the company owed.<sup>25</sup> On appeal, the remaining member argued that this value should be reduced by the members' contributions.<sup>26</sup> The court dismissed this argument, saying that it conflates "distribution to a withdrawing member of the value of his interest" with "a return of capital."<sup>27</sup>

#### ***Joint and Several Liability***

The trial court held Kennebrew, the remaining member of the LLC, was jointly and severally liable for the judgment, along with the company.<sup>28</sup> On appeal, the court found this to be error.<sup>29</sup> A member or manager of an LLC is not liable for the company's debts, obligations, or judgment unless the company agreement specifically provides otherwise.<sup>30</sup> Both the Company Agreement and the Management Agreement provided that no member or manager would be liable for company debts or liabilities, including a judgment.<sup>31</sup> Where a party prevails in a suit against the company and its members, and the causes of action on which the party prevails are on obligations of the company and not on obligations of the members, the company is solely responsible for satisfaction of the judgment.<sup>32</sup>

The withdrawing member prevailed on his claim for breach of contract of the Membership Agreement by the LLC in failing to repay money properly expended on the company's behalf and failure to distribute fair value of the membership interest, and he was awarded attorney's fees.<sup>33</sup> Both claims derive from contractual obligations of the company in the Management Agreement. No evidence showed the remaining member had any duty to perform in his personal

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<sup>20</sup> TEX. BUS. ORGS. CODE § 101.107 (West 2012).

<sup>21</sup> *Kennebrew*, 425 S.W.3d at 598.

<sup>22</sup> *Id.*

<sup>23</sup> *Id.*

<sup>24</sup> *Id.* at 598-99; *see also* TEX. BUS. ORGS. CODE § 101.205 (West 2012).

<sup>25</sup> *Id.*

<sup>26</sup> *Id.* at 599.

<sup>27</sup> *Id.*

<sup>28</sup> *Id.* at 600.

<sup>29</sup> *Id.*

<sup>30</sup> *See* TEX. BUS. ORGS. CODE § 101.114 (West 2012).

<sup>31</sup> *Kennebrew*, 425 S.W.3d at 600.

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*

capacity.<sup>34</sup> The court held it was improper to hold the member liable for a judgment against the LLC or attorney's fees where the grounds of recovery were against the LLC only.<sup>35</sup>

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<sup>34</sup> *Id.*

<sup>35</sup> *Id.* at 600-01.

## **CHOOSING THE APPROPRIATE STANDARD OF REVIEW WITH MERGERS BETWEEN A CONTROLLING STOCKHOLDER AND ITS SUBSIDIARY: THE BUSINESS JUDGMENT RULE V. ENTIRE FAIRNESS STANDARD**

By Dorian Thomas Hicks\*

*Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014).

In *Kahn v. M & F Worldwide Corp.*, the Supreme Court of Delaware affirmed the Court of Chancery's summary judgment in favor of the defendants in a dispute that arose from a 2011 going-private merger between MacAndrews & Forbes Holdings, Inc. ("M & F") and M & F Worldwide Corp. ("MFW").<sup>1</sup> M & F was a 43% stockholder in MFW when it proposed to purchase the remaining common stock of MFW.<sup>2</sup> Plaintiffs alleged breaches of fiduciary duty in the form of self-dealing.<sup>3</sup> The traditional standard of review to be applied when a plaintiff alleges self-dealing by a controlling shareholder is the "entire fairness" standard, where the defendant bears the burden to persuade the court that the transaction is entirely fair to the minority stockholders.<sup>4</sup> The Court of Chancery concluded that the "business judgment" standard of review in which the Plaintiff bears the burden of persuasion should apply rather than the "entire fairness" standard if, but only if:

the controller conditions the transaction on the approval of both a Special Committee and a majority of the minority stockholders;

(ii) the Special Committee is independent;

(ii) the Special Committee is empowered to freely select its own advisors and to say no definitively;

(iv) the Special Committee acts with care;

(v) the minority vote is informed; and

(vi) there is no coercion of the minority.<sup>5</sup>

The Court of Chancery concluded that the defendants met these conditions and the business judgment standard was appropriate.<sup>6</sup> Furthermore, the court found that the plaintiffs failed to raise any genuine issues of material fact that would preclude summary judgment.<sup>7</sup>

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<sup>1</sup> *Kahn v. M & F Worldwide Corp. (Kahn)*, 88 A.3d 635, 638 (Del. 2014).

<sup>2</sup> *Id.*

<sup>3</sup> *Id.*

<sup>4</sup> *Id.* at 642.

<sup>5</sup> *Id.* at 639.

<sup>6</sup> *Id.*

<sup>7</sup> *Id.*

In *Kahn v. Lynch Communication Systems, Inc.*,<sup>8</sup> the Supreme Court of Delaware had held that the defendants may shift the burden of persuasion to the plaintiff under the “entire fairness” standard by showing that either the transaction was approved by a Special Committee of independent Directors or the transaction was approved by an informed and uncoerced vote of the majority of the minority shareholders. In *Kahn v. M & F Worldwide Corp.*, the Court of Chancery was called upon to decide a matter of first impression regarding which standard of review to be applied when a merger between a controlling stockholder and its subsidiary is conditioned *ab initio* on approval of both a Special Committee of independent Directors and an informed and uncoerced vote of the majority of minority stockholders.<sup>9</sup>

MFW is a holding company in Delaware that was 43.4% owned by M & F.<sup>10</sup> M & F was entirely owned by Ronald O. Perelman.<sup>11</sup> The board of MFW consisted of thirteen Directors—three of those Directors were officers of both MFW and M & F.<sup>12</sup> Ronald Perelman was the chairman of MFW and the Chairman and CEO of M & F.<sup>13</sup> Barry Schwartz was the President and CEO of MFW and the Vice Chairman and Chief Administrative Officer of M & F.<sup>14</sup> William Bevins served as the Vice President of M & F.<sup>15</sup>

On June 13, 2011, Schwartz sent a letter to the MFW board on behalf of M & F proposing to buy the remaining shares of MFW.<sup>16</sup> M & F’s proposal included two procedural conditions to protect stockholder interests.<sup>17</sup> The first condition was that the merger be negotiated and approved by an independent Special Committee of MFW Directors.<sup>18</sup> The non-waivable second condition was that the merger be approved by a majority of the minority stockholder vote.<sup>19</sup> The proposal further stated that M & F had engaged independent financial and legal advisors, and that M & F would “encourage the Special Committee to retain its own legal and financial advisors to assist it in its review.”<sup>20</sup> M & F filed the proposal letter with the Securities and Exchange Commission and issued a press release disclosing substantially the contents of the proposal.<sup>21</sup>

On June 14, 2011, the MFW board met to consider the proposal.<sup>22</sup> After Schwartz presented the proposal to the board on behalf of M & F, he and Bevins recused themselves from the

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<sup>8</sup> *Kahn v. Lynch Commc’n Sys.*, 638 A.2d 1110, 1117 (Del. 1994).

<sup>9</sup> *Kahn*, 88 A.3d at 638.

<sup>10</sup> *Id.* at 640.

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

<sup>14</sup> *Id.*

<sup>15</sup> *Kahn v. M & F Worldwide Corp. (Kahn)*, 88 A.3d 635, 640 (Del. 2014).

<sup>16</sup> *Id.*

<sup>17</sup> *Id.*

<sup>18</sup> *Id.*

<sup>19</sup> *Id.*

<sup>20</sup> *Kahn*, 88 A.3d at 641.

<sup>21</sup> *Id.*

<sup>22</sup> *Id.*

meeting because they both held positions on the board of M & F.<sup>23</sup> The remaining independent Directors invited independent legal counsel to join the meeting.<sup>24</sup> The MFW Directors resolved to form the Special Committee and determined further that “[t]he Special Committee is empowered to make necessary investigations of the Proposal, evaluate the terms of the Proposal, negotiate the terms of the Proposal, report recommendations to the Board of Directors, and to elect not to pursue the Proposal. The Special Committee was empowered to retain independent legal counsel and financial advisors in connection with the transaction.<sup>25</sup> After the merger was approved by the Special Committee and a vote of 65.4% of MFW’s minority stockholders, excluding M & F and its affiliates, the merger closed in December of 2011.<sup>26</sup> The Plaintiffs then brought the original action against the defendants for breach of fiduciary duty.<sup>27</sup>

The Court of Chancery held that “rather than entire fairness, the business judgment standard of review should apply ‘if, but only if:<sup>28</sup> (i) the controller conditions the transaction on the approval of both a Special Committee and a majority of the minority stockholders; (ii) the Special Committee is independent; (iii) the Special Committee is empowered to freely select its own advisors and to say no definitively; (iv) the Special Committee acts with care; (v) the minority vote is informed; and (vi) there is no coercion of the minority.’”<sup>29</sup> The Court of Chancery concluded that the prerequisites for the usage of the business judgment standard of review, rather than entire fairness, were satisfied and the appellants “failed to raise any genuine issue of material fact indicating the contrary.”<sup>30</sup> The Court granted summary judgment for the defendants after reviewing the Merger using the business judgment standard of review.<sup>31</sup>

On appeal the appellants challenged the Court of Chancery’s summary judgment for two reasons.<sup>32</sup> First, the appellants claimed that the Directors included in the Special Committee were unable to discharge their duties impartially due to their lack of independence and intimidation from other Directors.<sup>33</sup> Second, they claimed that the majority of the minority votes were unduly influenced by experienced investors who were partial to approving transactions that offer market premiums because of the potential risk free profits associated with price inefficiencies.<sup>34</sup> The appellants also contended that even if both procedural protections were adopted, the “entire fairness standard should be retained as the applicable standard of review.”<sup>35</sup> The Appellees argued that the business judgment standard of review should be used because when both procedural protections were used and established pretrial, the going private merger became analogous to a “third-party arm’s length merger under Section 251 of the Delaware

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<sup>23</sup> *Id.*

<sup>24</sup> *Id.*

<sup>25</sup> *Kahn*, 88 A.3d at 641.

<sup>26</sup> *Id.* at 638.

<sup>27</sup> *Id.*

<sup>28</sup> Italicized by Court of Chancery, per *Kahn*, 88 A.3d at 639, n.2

<sup>29</sup> *Id.* at 639.

<sup>30</sup> *Id.*

<sup>31</sup> *Id.*

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*

<sup>34</sup> *Kahn v. M & F Worldwide Corp. (Kahn)*, 88 A.3d 635, 639 (Del. 2014).

<sup>35</sup> *Kahn*, 88 A.3d at 639, 643.

General Corporation Law.”<sup>36</sup>

The Supreme Court of Delaware affirmed the Court of Chancery’s summary judgment and agreed with the decision of The Court of Chancery in every part of its analysis. First, the Court articulated the circumstances that enable a controlled merger to be reviewed under the business judgment standard rather than the entire fairness standard.<sup>37</sup> Then the Court addressed whether those circumstances had been “established as a matter of undisputed fact and law in this case.”<sup>38</sup>

In order for the combination of Special Committee and majority of the minority stockholder approval to qualify jointly for business judgment review rather than entire fairness review, each procedural protection must be effective on its own to warrant a shift from entire fairness to business judgment.<sup>39</sup> The Supreme Court of Delaware began the analysis of the two protections by discussing the independence, mandate, and process of the Special Committee.<sup>40</sup> Next, the Supreme Court of Delaware analyzed the majority of the minority vote.<sup>41</sup>

The appellants specifically challenged the independence of three Special Committee members; Webb, Dihn, and Byorum.<sup>42</sup> The appellants questioned the impartiality of these Special Committee members because of their prior business or social dealings with Perelman.<sup>43</sup> In order to show that a Director is not independent, a plaintiff must show that the controlling shareholder influenced the Director to such an extent that the Director’s discretion was be sterilized.<sup>44</sup> In order to show such influence, the Plaintiff must meet a materiality standard which requires a conclusion from the Court that the “Director in question had ties to the person whose proposal or actions he or she is evaluating that are sufficiently substantial that he or she could not objectively discharge his or her fiduciary duties.”<sup>45</sup> The Supreme Court of Delaware concluded that mere allegations of social relationships or prior business dealings between two individual does not meet the materiality standard unless it is shown that those ties were material “in the sense that the alleged ties could have affected the impartiality of the individual Director.”<sup>46</sup>

With regard to the appellant’s challenge to the majority of the minority vote, the Supreme Court of Delaware agreed with the Court of Chancery’s conclusion that the Appellants failed to dispute the fact that the majority of the minority stockholder vote was fully informed and uncoerced because the Appellees made all proper disclosures and the Appellants failed to produce any evidence to the contrary.<sup>47</sup> On appeal, the appellants failed again to produce

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<sup>36</sup> *Id.* at 639.

<sup>37</sup> *Id.* at 646.

<sup>38</sup> *Id.*

<sup>39</sup> *Id.*

<sup>40</sup> *Id.*

<sup>41</sup> *Id.* at 646-47, 653-54.

<sup>42</sup> *Id.* at 647.

<sup>43</sup> *Id.*

<sup>44</sup> *Id.* at 648-49.

<sup>45</sup> *Id.* at 649.

<sup>46</sup> *Kahn*, at 649.

<sup>47</sup> *Id.* at 654.

evidence to the contrary.<sup>48</sup> The Supreme Court of Delaware affirmed the Court of Chancery's summary judgment and held that the "business judgment rule standard of review applies to this controlling stockholder buyout"<sup>49</sup>

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<sup>48</sup> *Id.*

<sup>49</sup> *Id.*

