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CONTENTS:

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CONFLICTING VIEWS AS TO THE UNFINISHED BUSINESS DOCTRINE

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Tara A. McGuire**

As the era of failed law firms, both large and small, continues,[1] so does debate as to the Unfinished Business Doctrine as most famously embodied in *Jewel v. Boxer*.[2] Notwithstanding its general acceptance over the last 30 years, it was recently rejected in New York. Demonstrating that New York was not setting a contrary trend, the Colorado Supreme Court subsequently affirmed the doctrine. This uncertainty as to the doctrine's application mandates that law and other professional firms consider and address the doctrine in their organizational agreements. Failure to do so only increases the likelihood of disputes, the expense of dispute resolution, and perhaps surprise as to the ultimate determination as to whether and how it should apply to a particular firm.

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[1] *See, e.g.*, Mudge Rose Guthrie Alexander & Ferdon v. Pickett, 11 F. Supp. 2d 449, 450 (S.D.N.Y. 1998) (factual discussion of Mudge Rose Guthrie Alexander & Ferdon firm dissolution in 1995); LaBrum & Doak, LLP v. Bechtle, 222 B.R. 749, 752 (Bankr. E.D. Pa. 1998) (factual discussion of LaBrum & Doak, LLP's dissolution in 1997); *see also* HERRICK K. LIDSTONE, JR., ISSUES IN PARTNER MIGRATION AND LAW FIRM DISSOLUTION 1–3, http://www.cobar.org/repository/Inside_Bar/Tax/migratory%20partners-law%20firm%20dissolution(1).pdf (reporting that Dickson, Carlson & Campillo dissolved in 1998; Altheimer & Gray dissolved in 2003; Adorno & Yoss LLP dissolved in 2011); Erin Fuchs, *The Eight Most Crushing Law Firm Implosions in the Nation's History*, BUSINESS INSIDER (Jun. 24, 2012, 11:30 AM), http://www.businessinsider.com/the-eight-most-spectacular-law-firm-collapses-in-history-2012-6 (reporting that Finley Kumble Wagner Heine Underberg Manley Myerson & Casey dissolved in 1988; Broback, Phleger & Harrison, LLP dissolved in 2003; Coudert Brothers LLP dissolved in 2005; Heller Ehrmann dissolved in 2008; Thelen LLP dissolved in 2008; Howrey LLP dissolved in 2011; Dreier LLP dissolved in 2009; Dewey Leboeuf dissolved in 2012); David Lat, *A Closer Look at the Morgan-Bingham Deal*, ABOVE THE LAW (Nov. 18, 2014, 1:02PM), http://abovethelaw.com/2014/11/a-closer-look-at-the-morgan-bingham-deal/ (reporting Morgan Lewis acquisition of Bingham McCutchen in 2014); Don Knox, *Breaking: Issacson Rosenbaum Will Close at Month's End*, LAW WEEK COLO. (Jun. 11, 2011), http://www.lawweekonline.com/2011/06/breaking-isaacson-rosenbaum-will-close-at-months-end (reporting that Isaacson Rosenbaum dissolved in 2011); Gus Lubin, *10 Huge Law Firm Collapses of the Decade*, BUSINESS INSIDER (Dec. 8, 2009, 7:30 AM), http://www.businessinsider.com/decades-biggest-law-firm-collapses-2009-12?op=1 (reporting that Thacher Proffitt & Wood LLP dissolved in 2008; Wolf Block Schorr & Solis-Cohen LLP dissolved in 2009; Jenkins & Gilchrist dissolved in 2007); Richard Piersol, *Harding & Shultz Law Firm is Dissolving*, JOURNAL STAR (Mar. 12, 2015, 11:00 PM), http://journalstar.com/business/local/harding-shultz-law-firm-is-dissolving/article_b5f1e841-1d7e-5ac0-bf51-9285a6147c02.html (reporting Harding & Shultz is dissolving), John Disney, *Morris Schneider Wittstadt Files for Bankruptcy*, DAILY REPORT (July 6, 2015), http://www.dailyreportonline.com/id=1202731432082/Morris-Schneider-Wittstadt-Files-for-Bankruptcy, Patrick George, *Clark, Thomas & Winters, Austin's Oldest Law Firm, Closes*, AUSTIN AM.-STATESMAN (Apr. 11, 2011), http://www.statesman.com/ news/news/local/clark-thomas-winters-austins-oldest-law-firm-close/nRY7w/ (reporting that Clark, Thomas & Winters is dissolving).

[2] 156 Cal.App.3d 171 (Cal. Ct. App. 1984).

JEWEL V. BOXER AND ITS PROGENY

The Unfinished Business Doctrine is exemplified by the decision rendered in *Jewel v. Boxer*, wherein the court considered the treatment of a contingency fee earned by one of two successor firms on a case that had been initiated with the predecessor firm.[3] Rejecting a formulaic division devised by the trial court, the court of appeals focused upon the language of the controlling partnership law—the attorneys had no written partnership agreement addressing the division of fees upon dissolution of the firm. Focusing upon the applicable partnership law, the court found that, (a) after dissolution, a firm continues for the purpose of completing partnership business,[4] and (b) no partner is entitled to additional compensation (*i.e.* compensation beyond the agreed sharing ratio under the original partnership agreement) for completing that partnership unfinished business.[5] Relying upon prior law including *Resnick v. Kaplan*,[6] the *Jewel* court held that all income derived from cases pending when the firm dissolved constitute firm assets that will be shared among the partners in accordance with their existing agreement. In rendering this decision the *Jewel* court expressly addressed claims that the rule it espoused interfered with a client's right to select counsel. Initially, it observed that,

> [E]ven though the client had the right to the attorneys of its choice, that right was irrelevant to the rights and duties between the former partners with regard to income from unfinished partnership business. . . . [T]he right of a client to the attorney of one's choice and the rights and duties as between partners with respect to income from unfinished business are distinct and do not offend one another.[7]

As for the claim that completing unfinished partnership business on these terms is disadvantageous to the partners performing the work because they would receive "only a portion of the income generated by such work," the court observed "this is all the former partners would have received had the partnership not dissolved."[8] Further, the burden would be shared by all former partners as to all unfinished business, so there is no particular burden imposed on any particular partner or partners to the exclusion of others.

Until recently, most states that have considered the question have followed the rule of

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[3] *Id.*, *superseded by statute*, CAL. CORP. CODE § 16401 (West 2014). There are pre-existing cases directing an outcome similar to that in *Jewel v. Boxer*. *See, e.g.*, Rosenfeld v. Cohen, 146 Cal.App.3d 200 (Cal.Ct.App. 1983), *overruled on other grounds by* Applied Equip. Corp. v. Litton Saudi Arabia Ltd., 869 P.2d 454 (Cal. 1994); Frates v. Nichols, 167 So.2d 77 (Fla. Dist. Ct. App. 1964).

[4] CAL. CORP. CODE § 15030 (repealed 1999) (verbatim adoption of UPA § 30 (1914)).

[5] CAL. CORP. CODE § 15018(f) (repealed 1999) (verbatim adoption of UPA § 18(f) (1914)).)

[6] 156 Cal.App.3d at 177 (citing Resnick v. Kaplan, 434 A.2d 582 (Md. Ct. Spec. App. 1980)). *Resnick* involved a dispute between two former partners to a dissolved law firm, one partner arguing that fees collected for work completed during the wind-up period should have been paid to him alone. 434 A.2d at 585. The appellate court upheld the trial court's determination that the collected fees were to be "allocated according to the percentages specified in the [partnership] agreement for the distribution of profits and losses." *Id.* at 587.

[7] *Id.* at 177–78. It should be noted that while it may have been that all of the unfinished business of the Jewel, Boxer and Elkind firm was based upon contingency fee arrangements, that is not stated in the opinion, and the court did not base its determination on the contingency fee basis of the work.

[8] *Id*. at 179.

Jewel v. Boxer.[9] For example, Texas courts have also followed the majority of states by adhering to the explicit terms of the partnership agreement when assessing ownership interests and profit distribution upon dissolution of a law firm. In *Kahn v. Seely*, the court reviewed appeals by two former law partners objecting to the trial court's 60/40 division of the firm's pre-dissolution profits and an award of post-dissolution services compensation in addition to the partnership interest.[10]

Seely had unilaterally acted to dissolve the partnership, after which Kahn argued that he was entitled to fifty percent of the firm's profits rather than forty percent, the percentage explicitly granted to him in the partnership agreement.[11] The court relied upon prior Texas case law, including *Dunn v. Summerville*,[12] and the 1914 Texas Uniform Partnership Act,[13] for the basic principle that "partnership profits are shared equally '[u]nless [the partners] otherwise agree . . . ."[14] The partnership agreement was found to unambiguously grant Kahn a forty percent interest in the profits of the firm, with the agreement further providing that if the partnership terminated for any reason other than death or disability, Kahn would "receive a percentage of the net fees and cases costs and loans equal to the percentage of ownership that he then possesses."[15]

The partnership agreement was not as explicit as to whether a partner would be entitled to compensation for post-dissolution services either in addition to or instead of the partner's share in the partnership profits, and the appellate court was required to fill the gap with the "no-compensation rule" of the Texas Uniform Partnership Act.[16] The Texas "no-compensation rule"[17] provided that "[n]o partner is entitled to remuneration for acting in the partnership business."[18] The appellate court rejected Kahn's argument that law partnerships are exempt from the "no-compensation rule," declining to follow *Cofer v. Hearne*,[19] an earlier Texas case holding to that effect. Instead, this appellate court joined with California's *Jewel v. Boxer* to follow the "majority rule" that every profession, including law partnerships, must be included

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[9] *See* Douglas R. Richmond, *Migratory Law Partners and the Glue of Unfinished Business*, 39 N. KY. L. REV. 359, n.120 (2012) (collecting cases). *See also* Christine Hurt, *The Limited Liability Partnership in Bankruptcy*, AMERICAN BUSINESS LAW JOURNAL (2016, forthcoming), BYU Law Research Paper No. 15-04, http://ssrn.com/abstract=2568461 (discussing the interplay of LLP status and partner limited liability versus creditor expectations of claim satisfaction in bankruptcy).

[10] 980 S.W.2d 794 (Tex. App.—San Antonio 1998, pet. denied).

[11] *Id.* at 796-97.

[12] 669 S.W.2d 319 (Tex. 1984).

[13] TEX. REV. CIV. STAT. ANN. art. 6132b, § 18 (West 1970) (expired 1999).

[14] *Kahn*, 980 S.W.2d at 797 (quoting *Dunn*, 669 S.W.2d at 319).

[15] *Id.*

[16] *Id.* at 798.

[17] TEX. BUS. ORG. CODE § 152.203(c) (West 2006) (formerly found in TEX. REV. CIV. STAT. ANN. art. 6132b, §18(1)(f), but modified to provide for reasonable compensation for post-dissolution services).

[18] *Id*. ("A partner is not entitled to receive compensation for services performed for a partnership other than reasonable compensation for services rendered in winding up the business of the partnership.") For a recent treatment of the no-compensation rule under the Texas Business Organizations Code, see Johnson v. Graze Out Cattle Co., 2012 Tex. App. LEXIS 5790 (Tex. App.—Amarillo July 18, 2012) (applying the no-compensation rule to characterize a $30,000 distribution to a former partner from partnership proceeds as a payout of the agreed percentage of partnership profits rather than as additional compensation for performance).

[19] 459 S.W.2d 877 (Tex. Civ. App.— Austin 1970, writ ref'd n.r.e.).

in the term "business" for the purposes of state partnership law.[20] The court ultimately held that when dissolution of a partnership is caused by withdrawal, Texas law "does not permit compensation for post-dissolution services in winding up the partnership's affairs," and reversed the trial court's order for post-dissolution compensation of Seely and Kahn.[21]

While questions of unfinished business often arise as to pending contingency fee cases, most courts that have considered the question, as well as most commentators, have applied the rule to contingency as well as hourly fees matters pending at the time of the firm's dissolution.[22] *Jewel* has as well been applied to firms of professionals other than attorneys[23] and, curiously, applied to firms organized as professional service corporations.[24] In fact, it is fair to describe the *Jewel* rule as the consensus for the next thirty years.[25] That consensus would be challenged and indeed broken in 2014.

THE CONSENSUS FAILS

Thelen LLP voted to dissolve in 2008 shortly after adopting a new partnership agreement containing a *Jewel* waiver, *i.e.*, an agreement that the firm would have no claim on the

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[20] *Kahn*, 980 S.W.2d at 799.

[21] *Id.*

[22] *See* Michael D. DeBaecke and Victoria A. Guilfoyle, *Law Firm Dissolutions: When the Music Stops, Does Anyone Need to Account for Any Unfinished Business?*, 14 DEL. L. REV. 41, 47, n.38 (2013); Dev. Specialist, Inc. v. Akin Gump Strauss Hauer & Feld LLP (In re Coudert Bros., LLP), 480 B.R. 145, 163-64 (S.D.N.Y. 2012) (collecting cases); In re Labrum & Doak, 227 B.R. 391, 410 (Bankr. E.D. Pa. 1998) ("[H]ourly-fees derived from work-in-progress pending at the time of dissolution are clearly property [of the firm]."); ROBERT W. HILLMAN, LAW FIRM BREAKUPS: THE LAW AND ETHICS OF GRABBING AND LEAVING § 4.4.3 (1990); ROBERT W. HILLMAN, HILLMAN ON LAWYER MOBILITY: THE LAW AND ETHICS OF PARTNER WITHDRAWALS AND LAW FIRM BREAKUPS § 4.6.1.2 (2nd Ed. 1998 & Supp. 2014 supp.) ("[T]here is no basis under partnership law for treating a matter billed in an hourly basis as something other than the unfinished business of a law partnership.") (italics deleted).

[23] *See* DeBaecke & Guilfoyle, *supra* note 22, at n.3.

[24] *See, e.g.*, Sullivan, Bodney & Hammond, Prof'l Corp. v. Bodney, 820 P.2d 1248 (Kan. Ct. App. 1991); Fox v. Abrams, 210 Cal. Rptr. 260 (Cal. Ct. App. 2d Dist. 1985); Marr v. Langhoff, 589 A.2d 470 (Md. 1991). This treatment is curious in that corporate law generally does not incorporate an analytic underpinning of *Jewel*, namely the no compensation rule of partnership law. In *Fox* the Court wrote: "it is well-known that the primary purpose of the laws permitting professionals to incorporate was to allow them to take advantage of various tax benefits available to corporate employers and employees." 210 Cal. Rptr. at 265. This discounting of incorporation ignores the fact that it could have been done to avoid implications and consequences of organization as a partnership. *See also* Frank Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271, 298 (1986) ("Proponents of the partnership analogy assume that participants in closely held corporations are knowledgeable enough to incorporate to obtain the benefits of favorable tax treatment or limited liability but ignorant of all other differences between corporate and partnership law.")

[25] *See* Richmond, *supra* note 9. This is not to suggest, however, that the rule of *Jewel v. Boxer* had universal acceptance. *See, e.g.*, Mitchell v. Brewer, 2013 NCBC 14, 2013 WL 765372 (N.C. Super. Feb. 26, 2013) (in the context of a law firm LLC declining to follow *Jewel v. Boxer* and instead awarding former firm quantum merit claim against ultimate proceeds of contingency fee case). The *Mitchell* decision relied in part upon the decision rendered in *Lamb v. Wilson*, 92 N.W. 167 (Neb. 1902). The *Lamb* decision was relied upon as well in *Cafer v. Hearne*, 459 S.W.2d 877 (Tex. Civ. App.—Austin 1970, writ ref'd n.r.e). The court in *Kahn v. Seely* declined to follow *Cofer v. Hearne*, instead deciding to adopt the "majority rule." *Kahn*, 980 S.W.2d at 796. The *Kahn* court did not expressly overrule *Cofer*, but in discussing it stated that "*Cofer* is thus contrary to the express terms of the statute [Tex. Rev. Civ. Stat. Ann. art. 6132b, §6(1)] and the majority rule and is 'plainly wrong,' as several courts have noted." The court references *Jewel v. Boxer* as one of the courts noting the error in the *Cofer* decision. *Id.* at 799.

proceeds of any cases or matters ongoing at the time of dissolution save collection of then accrued but unpaid fees. Just less than a year later Thelen entered chapter 7 bankruptcy. Thelen's chapter 7 trustee sought to have the *Jewel* waiver set aside as a constructive fraudulent transfer and to collect for the Thelen estate the fees earned on the transferred unfinished business. Seyfarth, one of the firms to which Thelen attorneys had moved, was successful in its argument to the trial court that the Unfinished Business Doctrine does not apply to hourly matters.[26] The story was largely similar at Coudert Brothers LLP. Its partners agreed to dissolve in August 2005, and granted the executive committee the right to waive partnership claims; although not express in this decision, the granted waivers presumably included claims on fees earned after separation and transfer of cases and matters to different firms. Coudert filed for bankruptcy in September 2006. Developmental Specialists, Inc. ("DSI"), as administrator of Coudert's estate, brought suit against firms to which Coudert attorneys moved, seeking the proceeds of the transferred work. The defendants asserted that the *Jewel* doctrine does not apply to hourly (as contrasted with contingent) fee arrangements; the bankruptcy court did not accept that argument. Rather, it held that the *Jewel* doctrine did apply, and that "the Client matters were Coudert assets on the dissolution date. Because they are Coudert assets, the former Coudert partners are obligated to account for any profits they earned while winding the Client Matters up at the Firms."[27]

Seeking resolution of these determinations, the Second Circuit Court of Appeals certified to the New York Court of Appeals the following question:

> Under New York law, is a client matter that is billed on an hourly basis the property of a law firm, such that, upon dissolution and in related bankruptcy proceedings, the law firm is entitled to the profit earned on such matters as the 'unfinished business' of the firm?[28]

The New York Court of Appeals would hold in the negative, the proceeds of transferred hourly matters are not assets of the prior firm and may not be claimed by the bankruptcy estate in order to satisfy those creditor claims.[29] Not squarely addressing *Jewel's* reliance on UPA §§ 18(f) and 30,[30] the *Thelen* Court focused upon what is "property" of the partnership, holding that as a firm has no enforceable property interest in the matters entrusted to it by clients, there

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[26] Geron v. Robinson & Cole LLP, 476 B.R. 732, 742-43 (S.D.N.Y. 2012).

[27] Dev. Specialists, Inc. v. Akin Gump StraussHauer & Feld LLP, 477 B.R. 318, 326 (S.D.N.Y. 2012).

[28] In re Thelen, 20 N.E.3d 264, 268 (N.Y. 2014).

[29] A similar determination that hourly matters are not unfinished business was reached in Heller Ehrman LLP v. Davis, Wright, Tremains, LLP, 527 B.R. 24, 26 (Bankr. N.D. Cal. June 11, 2014). The Unfinished Business Doctrine, as least as to contingency matters, had prior to these decisions been accepted in New York. *See*, *e.g.*, Shandell v. Katz, 629 N.Y.S.2d 437 (N.Y. App. Div. 1st Dept. 1995); McDonald v. Fenzel, 650 N.Y.S.2d 9 (N.Y. App. Div. 1st Dept. 1996). As to hourly fees the question was open. *See* Sheresky v. Sheresky Aronson Mayefsky & Sloan, LLP, 35 Misc. 3d 1201(A), 950 N.Y.S.2d 611 (Table), (N.Y. Sup. Ct. 2011) ("This being said, the court is not inclined to recognize a cause of action for unfinished business for hourly fee cases which has, hitherto, not been recognized by the New York courts.")

[30] *See also* Joan C. Rogers, *Profits From Finishing Bankrupt Firms' Cases Belong to Law Firms That Complete Them*, 83 LAW WEEK (BNA July 8, 2014) ("Hillman noted that while *Geron* addressed policy concerns and the problems facing lawyers and firms, 'it gave the statute fairly short shrift.' The court did not mention a couple of the most pertinent statutory provisions in the partnership law, nor did it discuss the effect on creditors, he said.").

is no property right against which the firm may make a claim after dissolution.[31] Furthermore, the court held that the Unfinished Business Doctrine, as applied in *Jewel*, "would have numerous perverse effects," including that, "[b]y allowing former partners of a dissolved firm to profit from work they do not perform, all at the expense of a former partner and his new firm, the trustees' approach creates an 'unjust windfall' . . . ."[32] Expanding on this point, the court also wrote, "[A]ttorneys would simply find it difficult to secure a position in a new law firm because any profits from their work for existing clients would be due their old law firms, not their new employers."[33] Ultimately, the *Thelen* decision rests upon the impact of a *Jewel* doctrine obligation among partners upon the perceived ability of clients to retain counsel of their choosing.[34]

ARE *THELEN* AND *COUDERT BROTHERS* ANOMALIES?

Going against *Thelen* is a recent decision of the Colorado Supreme Court in which it upheld the *Jewel* rule in the context of a law firm organized as a Colorado LLC.[35] LaFond & Sweeney LLC was organized in 1995 and dissolved in 2008; at the time of its dissolution several cases, most notably the Maxwell False Claims Act action undertaken on a contingency basis, were pending. The Maxwell case went with LaFond to his new firm. Sweeney and LaFond were unable to come to agreement as to the division of any ultimate settlement in the Maxwell case. The trial court issued a quantum meruit judgment in favor of the L&S firm in the amount of up to $597,179.88 to then be divided equally between LaFond and Sweeney. Shortly after this decision was rendered Maxwell's qui tam action generated a judgment of some $23 million with additional attorney fees of $2.2 million; the case ultimately settled for some $26 million and $2.6 million in attorney fees (with the contingency fee still in place; that percentage is not recited in the decision). Maxwell appealed, and the Colorado Court of Appeals held that the quantum meruit analysis of the trial court was improper, and that all proceeds of the contingency fee arrangement were firm property to be divided in accordance with LaFond and Sweeney's agreed sharing ratios of 50% each. This determination was affirmed by the Colorado Supreme Court.

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[31] *In re Thelen*, 20 N.E.3d at 270-71 ("In short, no law firm has a property interest in future hourly legal fees because they are 'too contingent in nature and speculative to create a present or future property interest', given the client's unfettered right to hire and fire counsel.") (quoting Verizon New England, Inc. v. Transcom Enhanced Servs., Inc., 21 NY3d 66, 72 (N.Y. 2013)).

[32] *In re Thelen*, 20 N.E.3d at 273. As is discussed below, at least in those states that have adopted RUPA, a partner working to complete the prior firm's business is entitled to reasonable compensation for doing so. *See infra* notes 48 through 53 and accompanying text. In those jurisdictions, this aspect of the *Thelen* court's reasoning is inapplicable.

[33] *Id.* .

[34] *See also* 1 GEOFFREY C. HAZARD, JR., W. WILLIAM HODES, & PETER R. JARVIS, THE LAW OF LAWYERING (4th ed.) § 5.21 at 5-85:

> [I]f a lawyer moved to a new firm but had to spend a significant amount of time finishing up old firm work, the new firm would be placed in the untenable position of paying for the lawyer's portion of overhead, without being able to realize a return on it. This would make the new firm less willing to welcome the new lawyer into its ranks, and that would have the cascading effect of making it more difficult for clients of the old firm to assure that their legal business was being attended to by counsel knowledgeable about their affairs.

[35] LaFond v. Sweeney, 343 P.3d 939, 951 (Colo. 2015).

The Colorado LLC Act requires each member to "hold as trustee for it any property, profit or benefit derived . . . in the winding up" of the LLC's business.[36] Unlike Colorado's current partnership act, an adoption with modification of the Revised Uniform Partnership Act which affords a partner the right to compensation for services rendered in completing business pending at the time of the partnership's dissolution, the Colorado LLC Act is silent as to such a right of compensation.[37]

Substantively, the court first determined that a contingency fee case is firm property:

> That a pending contingency fee case is business of a dissolved LLC follows from the fiduciary nature of the attorney-client relationship. With respect to law firms, absent a special agreement, the client employs the firm and not a particular lawyer. During the dissolution of a law firm, attorneys continue to owe clients ethical and legal duties such as ensuring that the client's matter is handled properly.[38]

Tellingly, and here significantly departing from the *Thelen* decision, the Colorado Supreme Court found that, notwithstanding Maxwell's decision that LaFond should handle the matter after the dissolution:

> Maxwell's choice in this regard did not alter the contingent fee agreement that was in existence at the time of L&S's dissolution; nor did it alter the rights and duties LaFond and Sweeney owed to each other under their business arrangement. The contingent fee agreement remained in place, and LaFond had a duty to carry forward the representation undertaken by the LLC. Accordingly, the *Maxwell* case constituted business of the LLC for the purposes of determining the rights and duties of LaFond and Sweeney toward each another.[39]

In response to LaFond's argument that this application of the Unfinished Business Doctrine interferes with the client's right to counsel, in that "an attorney would be unwilling to represent the client unless the attorney is entitled to additional compensation for his work,"[40] the Colorado Supreme Court wrote the following:

> We are unaware of any authority for the proposition that fiduciary duties attorneys owe to their firms may be eschewed under the circumstances of a case like the one before us. The division of the contingent fee between LaFond and Sweeney does not affect the amount of money Maxwell had to pay upon successful resolution of his case. Hypothetical harm, as opposed to actual harm to the client's ability to choose counsel in the case, is not a pertinent consideration when determining the rights and

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[36] COLO. REV. STAT. § 7-80-404(1)(a) (West 2015). *Accord* REV. UNIF. P'SHIP ACT § 404(b)(1), 6 (pt. I) U.L.A. 143 (2001); UNIF. P'SHIP ACT § 21, 6 (pt. II) U.L.A. 194 (2001).

[37] *See* COLO. REV. STAT. § 7-64-401(8) (West 2015); REV. UNIF. P'SHIP ACT § 401(h), 6 (pt. II) U.L.A. 133 (2001).

[38] *LaFond*, 343 P.3d at 945.

[39] *LaFond*, 343 P.3d at 946 (footnote omitted).

[40] *LaFond*, 343 P.3d at 947.

> obligations of attorneys to their firms. *See Jewel*, 203 Cal. Rptr. at 17 ("[T]he right of a client to the attorney of one's choice and the rights and duties as between partners with respect to income from unfinished business are distinct and do not offend one another.").[41]

Clearly *In re Thelen* and *LaFond* cannot be reconciled.[42] While at first blush it might be said that one is a case about hourly fee arrangements and the other contingency fees, that differentiation does not stand up to scrutiny. The determination made in *Thelen* as to what is firm property is applicable to both types of engagements. Likewise, the *LaFond* determination as to what constitutes ongoing business at the time of dissolution is equally applicable to contingent and hourly arrangements.

IN FAVOR OF *JEWEL* AND THE UNFINISHED BUSINESS DOCTRINE

Setting aside for now those firms that utilize a *Jewel* waiver, a topic further discussed below, clearly there is now a split as to the proper default rule. In California, New York, and Colorado it is clear as to what is the default rule. Obviously the question remains open in the vast majority of jurisdictions in this country and as well in different organizational forms—how might *LaFond* be decided under Colorado's enactment of RUPA, and how might *Jewel* be decided under California's new LLC Act? While available space does not permit a complete explication of the question, in our view the *LaFond* decision, it continuing the rule of *Jewel*, is the better policy.

An important function of the Unfinished Business Doctrine is to police otherwise opportunistic behavior by partners. If a partner cannot expect to make more off a file by working the case in the current firm than she would were she to dissolve the firm and leave with the file, the incentive to depart is eliminated. Consider firm ABC. During the partnership's term, B originates a particularly lucrative contingent fee case. B is aware that if the case is resolved while she is part of ABC that she will realize 30% of the net recovery; A and C will equally split the balance of 70% of the recovery. Absent the Unfinished Business Doctrine, B has a significant incentive to dissolve ABC by withdrawing therefrom and (with client consent) taking this case with her, all with an eye to keeping for herself 100% of the ultimate recovery offset only by ABC's claim in quantum meruit.[43] Likewise, absent the

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[41] *Id. Accord* Ellerby v. Spiezer, 485 N.E.2d 413, 416 (Ill. App. Ct. 1985) ("This right of the client is distinct from and does not conflict with the rights and duties of the partners between themselves either respect to profits from unfinished partnership business because since, once the fee is paid to an attorney, it is if no concern to the client how the fee is distributed among the attorney and his partners.").

[42] With due respect, the statement by Anthony Davis to the effect that the *Thelen* and *Heller Ehrman* decisions "represent the death of the unfinished business doctrine," overstated the situation unless his intention was to address only the law within New York. *See* Joan C. Rogers, *Profits From Finishing Bankrupt Firms' Cases Belong to Law Firms That Complete Them*, 83 LAW WEEK (BNA July 8, 2014).

[43] *See, e.g.*, Fracasse v. Brent, 494 P.2d 9, 13 (Cal. 1972); Barker v. Shapero, 203 S.W.3d 697, 699 (Ky. 2006). *See also* ROBERT L. ROSSI, 1 ATTORNEYS' FEES § 3:12 (3d ed. 2014) ("It is now fair to say that the overwhelming majority of jurisdictions hold that an attorney employed on a contingent fee contract who is discharged without fault on his part before the happening of the contingency is not entitled to recover on the contract, but may recover merely on a quantum meruit basis the reasonable value of the services rendered."); George L. Blum, *Limitation to quantum meruit recovery, where attorney employed under contingent-fee contract is discharged without cause*, 56 A.L.R. 5th 1, *3a (1998) (listing twenty-eight states and the District of Columbia as supporting the proposition "that an attorney

Unfinished Business Doctrine, presuming they are unwilling to accept only a quantum meruit recovery, A and C will have a claim for abusive termination by B of ABC. One benefit of the *Jewel* rule is that it preserves the agreement of the parties and avoids separate challenges based in bad-faith and breach of fiduciary duty.[44]

Another benefit of the Unfinished Business Doctrine is that it is consistent with default partnership law. Partners are free to negotiate a different rule. The fact that partners may not want to "jinx" the deal by focusing upon dissolution when forming the partnership is of no import.[45] At a time when the partners are negotiating any number of items, some of which, such as sharing ratios, are zero sum, they should either negotiate matters involving the dissolution of the venture or accept the consequences of the law's default rules.[46] Absent such private ordering, the *Jewel* Doctrine carries forward for all partners what was the agreement under which they have performed during the partnership's pendency. Not only is the partners' inter-se agreement preserved, but time-consuming disputes as to the treatment of income from individual matters are avoided.[47]

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employed on a contingent-fee contract who was discharged without fault on his or her part is not entitled to recover the full compensation on the contract, but is limited to a quantum meruit recovery."). *But see id.* at *4 (listing jurisdictions whose laws support the proposition that "an attorney employed on a contingent-fee contract who was discharged without fault on his or her part is not limited to a quantum meruit recovery but is entitled to recover the full compensation stipulated in the contract, on the theory of either constructive performance or breach of contract"); Howell v. Kelly, 534 S.W.2d 737, 739 (Tex. Civ. App.—Houston [1st Dist.] 1976, no writ) ("[A]n attorney under a contingent fee contract is permitted to recover on the contract in Texas"). *See also* Adam Shajnfeld, *A Critical Survey of the Law, Ethics, and Ecomonics of Attorney Contingent Fee Arrangements*, 54 N.Y.L. SCH.. L. REV. 773 (2009/2010) (reviewing distinctions between the laws of the various jurisdictions that restrict attorney contingency recovery to quantum meruit in circumstances of discharge other than for cause).

[44] *See, e.g.*, Page v. Page, 359 P.2d 41 (Cal. 1961); Leff v. Gunter, 658 P.2d 740 (Cal. 1983); Rosenfeld, Meyer & Susman v. Cohen, 146 Cal.App.3d 200 (Cal. Ct. App. 1983), *disapproved of by* Applied Equip. Corp. v. Litton Saudi Arabia Ltd., 869 P.2d 454 (Cal. 1994) (holding partners' withdrawal from partnership in order to lure a major partnership client to their newly formed firm was in bad faith). Additional scrutiny of these problems is set forth in J. Hart, *Termination of the Fiduciary Duty of Business Associates Not To Compete for the Firm's Customers and Suppliers*, 14 DUKE L.J. 16 (1954); Thomas E. Rutledge, *Care and Loyalty After the Dissociation From or Dissolution of an Unincorporated Entity*, in RESEARCH HANDBOOK ON PARTNERSHIPS, LLCS AND ALTERNATIVE FORMS OF BUSINESS ORGANIZATIONS (Robert W. Hillman & Mark J. Loewenstein eds., 2015).

[45] *See also* Mark H. Epstein & Brandon Wisoff, *Winding Up Dissolved Law Partnerships: The No-Compensation Rule and Client Choice*, 73 CALIF. L. REV. 1597, 1614 (1985) ("Of course, the partners can agree by contract to provide for compensation in the event winding-up burdens fall inequitably. Nevertheless, because partnerships are likely to be forged in an atmosphere of optimism and mutual respect, partners may suppress notions of dissolution and conflict. Should the various partners consider the potential problems involved in dissolving, they may choose not to raise the issue for fear of disrupting the harmony of the moment.").

[46] *See also* Thomas E. Rutledge, *Shareholders Are Not Fiduciaries—A Positive and Normative Analysis of Kentucky Law*, 51 LOUISVILLE L. REV. 535, 559–60 (2012–13).

[47] *See also* Mark I. Weinstein, *The Revised Uniform Partnership Act: An Analysis of Its Impact on the Relationship of Law Firm Dissolution, Contingent Fee Cases and the No Compensation Rule*, 33 DUQ. L. REV. 857, 867 (1995) ("A significant advantage of the No Compensation Rule is its practicality due to its mechanical application. In implementing the rule, courts need not examine the dissolution process on an ad hoc basis to determine the fee proportion owed to each partner. The automatic application of the No Compensation Rule by courts also encourages private dispute resolution. Abandoning the rule in favor of quantum meruit compensation would force courts to examine, weigh, and formulate various factors to determine the amount of compensation owed to former partners. Courts would have to determine what percentage of the fee was accrued before and after dissolution, the expected value of the case, and how much time the partner actually spent working on the case.") (footnote omitted).

An important change in the underlying law has been the abandonment of the no compensation rule of UPA § 18(f) and the adoption of a reasonable compensation rule as set forth in RUPA § 401(h).[48] At first blush this differential between the partnership acts could indicate that partnerships governed by the new law[49] should not be subject to the rule of *Jewel v. Boxer*. Almost certainty this overstates the case. In a partnership governed by RUPA § 401(h), a partner completing partnership business is entitled to "reasonable compensation" for completing partnership business as part of its winding up. Seldom if ever will "reasonable compensation" equal all proceeds of that engagement.

While there is to date a dearth of case law on the interpretation of RUPA § 401(h), one paradigm would be to consider the claim as in the nature of a quantum meruit action by the partner against the firm.[50] Once the value of the services rendered in completing the partnership business has been thereby determined, the net proceeds would be firm assets divided among all of the partners in accordance with the sharing ratios set forth in the partnership agreement.[51] In addition, the "reasonable compensation" provided for in RUPA § 401(h) provides for disparate treatment among the partners who oversee and conclude the firm's unfinished business. Partners who undertake the more onerous tasks will be compensated for doing so while those who complete the less strenuous tasks will receive proportionally less compensation for the services rendered on the partnership's behalf.[52] In consequence, RUPA's adoption of a compensation rule, in opposition to UPA's no compensation rule, only adds another step in the process but does not otherwise alter the Unfinished Business Doctrine, even as it militates a perceived negative consequence of the prior law.[53]

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[48] *See* REV. UNIF. P'SHIP ACT § 401(h), 6 (pt. I) U.L.A. 133 (2001) ("A partner is not entitled to remuneration for services performed for the partnership, except for reasonable compensation for services rendered in winding up the business of the partnership"). *Compare* UNIF. P'SHIP ACT § 18(f) (1914), 6 (pt. II) U.L.A. 101 (2001) ("No partner is entitled to remuneration for acting in the partnership business, except that a surviving partner is entitled to reasonable compensation for his services in winding up the partnership affairs.").

[49] RUPA has been adopted in thirty-six states, the District of Columbia and the Virgin Islands. *See* REV. UNIF. P'SHIP ACT, 6 (pt. I) U.L.A. (Supp. 2014) 1.

[50] The comments to RUPA provide no guidance as to how this "reasonable compensation" is to be determined. *See also* Weinstein, *supra* note 47, at 859 ("[T]he drafters did not provide or articulate a standard, formula, or methodology to be utilized by courts faced with this issue of requested compensation.").

[51] *See also id*. at 879–84 (setting forth a paradigm for determining adequate compensation under RUPA § 401(h)).

[52] *See also id*. at 875 ("The phenomenon of "lock out" can be avoided by the RUPA Section 401(h). The financial disincentive of completing a particular client's contingent fee case which requires a disproportionate amount of time and effort, is eliminated by awarding compensation to an attorney who has excessive winding up burdens.").

[53] *See also* Joan C. Rogers, *Profits From Finishing Bankrupt Firms' Cases Belong to Law Firms That Complete Them*, Bloomberg BNA (July 16, 2014), http://www.bna.com/profits-finishing-bankrupt-n17179892367/ ("Under RUPA, he explained, partners are entitled to reasonable compensation for winding up a dissolved firm's business; accordingly, former partners of a dissolved firm and their new firms would not be deprived of all recompense for their work if the unfinished business doctrine were applied. Because RUPA furnishes a way out from the dilemma that lawyers and firms face in UPA states by allowing firms to finish business but be compensated, courts applying RUPA may be more likely to accept the unfinished business doctrine for hourly fee matters that former partners of dissolved firms take to other firms, Hillman said.").

PROTECTION OF GENERAL CREDITORS

While the objective of the Unfinished Business Doctrine is to recover to the partnership the fruits of those projects in process at the time of dissolution with the objective of sharing the net proceeds among the partners in accordance with their agreed sharing ratios, it must be recognized that the rule first protects the rights of partnership creditors.[54] As exemplified by the Thelen and Coudert Brothers bankruptcy cases, third-party creditors of the firms remain unpaid; consequent to elections by the firms to be limited liability partnerships the personal assets of the partners are not available to satisfy those creditors.[55] If firm assets do not include unfinished business, then the creditors are restricted to collections on accounts receivable outstanding as of the firm's dissolution/bankruptcy. It will be common for those assets to be insufficient to satisfy those creditor claims.[56] While the shifting of risk to unsecured creditors is the accepted and intended effect of affording business owners limited liability,[57] firms advertise their credit worthiness based on factors including their history of exploiting client relationships and the income being currently derived from them.[58] Creditors may legitimately assert that they extended credit against the firm's recognition of that income. One may question whether New York's rejection of the Unfinished Business Doctrine works an unjust hardship upon the creditors of those firms. Will lenders now insist upon a loan covenant precluding the inclusion in the partnership agreement of a *Jewel* waiver and require the partnership agreement to define as partnership property the proceeds realized upon all engagements existing at the time the firm dissolves?

PROTECTION OF RETIRED PARTNERS

As a subset of creditors as discussed above, there are retired partners who have claims on

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[54] *See, e.g.*, Richmond, *Migratory Law Partners*, *supra* note 9, at 362 ("But dissolved law firms have creditors, and firms that either voluntarily or involuntarily enter bankruptcy following dissolution create estates administered by bankruptcy trustees who are charged with maximizing the value of the estate."). *See also* UNIF. P'SHIP ACT § 38, 6 (pt. II) U.L.A. 487 (2001); N.Y. P'SHIP ACT § 69. *Accord* TEX. BUS. ORG. CODE § 152.706(a); KY. REV. STAT. ANN. § 362.1-807(1); REV. UNIF. P'SHIP ACT § 807(a), 6 (pt. I) U.L.A. 206 (2001); *id.* cmt. 2 ("Subsection (a) continues the rule of UPA Section 38(d) that, in winding up the business, the partnership assets must first be applied to discharge partnership liabilities to creditors.")

[55] *See, e.g.*, N.Y. P'SHIP ACT § 121-1500; DEL CODE ANN. tit. 6, § 1550; TEX. BUS. ORG. CODE § 152-801(a).

[56] Another source of funds, depending upon state law, will be the recovery of partner distributions made when the firm was insolvent. *See, e.g.*, DEL. CODE ANN. tit. 6, § 15-309 (2000); KY. REV. STAT. ANN. § 362.1-932 (2013). Neither New York nor Texas has an equivalent provision.

[57] *See, e.g.*, I. MAURICE WORMSER, DISREGARD OF THE CORPORATE FICTION AND ALLIED CORPORATION PROBLEMS 18 (Baker Voorhis & Co., 1927) ("The policy of our law to-day sanctions incorporation with the consequent immunity from individual liability. It follows that no fraud is committed in incorporating for the precise purpose of avoiding and escaping personal responsibility. Indeed, that is exactly why most people incorporate, and those dealing with corporations know, or at least are presumed to know, the law in this regard."); Stephen M. Bainbridge, *Abolishing LLC Veil Piercing*, 2005 U. ILL. L. REV. 77 (2005) ("It is generally accepted that limited liability creates negative externalities. Limited liability allows equity holders to cause the firm to externalize part of the risk and costs of doing business onto other constituencies of the firm and, perhaps, even onto society at large.").

[58] *See, e.g.*, Private Placement Memorandum from Dewey & Leboeuf LLP 18 (Martin 2010), http://chapter11cases.com/2012/05/10/read-the-private-placement-memorandum-for-dewey-leboeufs-125-million-senior-secured-notes/ ("Client relationships historically have tended to be long-term due to the in depth client knowledge Dewey maintains to provide exceptional service. The level of trust and familiarity fostered by the long-standing relationships with Dewey's clients help minimize the risk of losing clients to competitors.")

firm assets by reason of non-ERISA benefit plans which provide, *inter alia*, for certain payments post-retirement, typically but not necessarily based upon some function of the retired partner's income in the years preceding retirement. Absent the Unfinished Business Doctrine these obligations are, being charitable, at risk.

By way of example, in March 2015 the Lincoln, Nebraska firm of Harding Shultz announced it was dissolving.[59] According to a press report, the dissolution of the firm was precipitated by two partner's retirements, which triggered certain payment obligations.[60] Reading between the lines, other attorneys had no interest in working to fund those obligations and left, ultimately precipitating the firm's demise.[61]

Moving from the particulars of the Harding Shultz firm, partners who anticipate often significant payments upon retirement may find those commitments to be illusory if the Unfinished Business Doctrine is not applied. Assuming the firm has elected a limited liability structure,[62] the firm's assets will be those on hand as of dissolution plus the accounts receivable that are ultimately collected. Even assuming that the obligation to make the retirement payments have a higher priority than other claims, it cannot be expected that those accounts will satisfy the debts undertaken in prior years. Conversely, application of the Unfinished Business Doctrine generates additional funds, through which the firm may discharge those obligations.

THE COST & EFFECT OF A *JEWEL* WAIVER

As is often the rule in business organizations, this question can be avoided by careful drafting of the organic document. Some firms will include a *Jewel* waiver.[63] To include such a provisions is their decision and one which should be taken only after consideration of the impact of that provision on firm unity and possible negative consequences to those attorneys who post-dissolution do not share in the fee generated on a case pending at the time of dissolution. Imagine the firm of ABCD, which dissolves while a significant fee matter (whether it is contingent or not does not matter), is party to a lease on which each of A, B, C and D are personally responsible either by reason of partner status or a personal guarantee. At the time of dissolution the remaining obligation on the lease is $200,000. A month after dissolution that fee comes in; by happy coincidence it is $200,000. If the $200,000 goes to successor firm CD, each of C and D has income with which to discharge their obligations under the lease; neither A nor B is so benefited. Conversely, if the $200,000 is property of

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[59] *See* Richard Piersol, *Harding and Shultz Law Firm is Dissolving*, JOURNALSTAR.COM (Mar. 12, 2015), http://journalstar.com/business/local/harding-shultz-law-firm-is-dissolving/article_b5f1e841-1d7e-5ac0-bf51-9285a6147c02.html.

[60] *See* Martha Neil, *Law firm is dissolving after nearly 60 years; senior partner points finger at retirement plan*, ABA JOURNAL.COM (Mar. 13, 2015), http://www.abajournal.com/news/article/law_firm_is_dissolving_after_nearly_60_years_senior_partner_points_finger/?utm_campaign=weekly_email&utm_source=maestro&job_id=150319AX&utm_medium=email.

[61] *See also* Jeff Blumenthal, *Wolf Block work still unfinished*, PHILADELPHIA BUSINESS JOURNAL (Mar. 22, 2010), http://www.bizjournals.com/philadelphia/stories/2010/03/22/story2.html ("But the biggest issue of contention could be retired partners who lost their pension because of Wolf Block's unfunded pension plan. Those retirees must stand in line with other creditors.")

[62] Harding Shultz was organized on a professional corporation. *See also supra* note 24.

[63] *See also* HILLMAN, *supra* note 22, § 4.6.1.1 (discussing *Jewel* waivers).

ABCD, all of their obligations under the lease can be extinguished.

In effect, a *Jewel* waiver may perversely weaken the bonds which (should) hold a firm together by in effect encouraging each partner to be continuously on the lookout for opportunities to depart and thereby precipitate dissolution, taking engagements which look to be promising when the firm's claim under quantum meruit is low relative to the expected payoff. In light of that eventuality it can be determined that a *Jewel* waiver should be rejected in the organic agreement.

THELEN AND *COUDERT BROTHERS* GO TOO FAR IN RELYING UPON CLIENT CHOICE

The crux of the *Thelen* and *Coudert Brothers* decisions is that application of the Unfinished Business Doctrine would limit client choice by restricting the ability of attorneys to move from dissolved firms to new firms. On closer analysis the courts' reasoning is questionable.

In the context of a firm dissolution any number of factors may preclude a client following one or more attorneys to a new firm. There may be a conflict which precludes that engagement from transitioning.[64] The new firm may have a fee structure that the client finds undesirable. The client may have had an adverse relationship with that new firm such that they are not willing to transition their files to that firm. For these and any number of other reasons a client may either elect not to transfer an engagement to an attorney's new firm or be precluded from doing so. Simply put, a lawyer leaving one firm is under no obligation to insure that his or her new firm is acceptable to an existing client.

Second, as to the argument that clients may be, consequent to the Unfinished Business Doctrine, locked out of the counsel they desire, it is only that, an argument.[65] With a majority of jurisdictions having to date followed *Jewel*, it would be expected that the cases and commentary would recite incidents of lock-out. It is at minimum curious that such a calamitous outcome, one sufficient to justify the New York Court of Appeals setting aside the text of the Uniform Partnership Act, cannot be shown to have ever occurred.

Third, the *Thelen* Court's reasoning is that, inter-se, business organization law be damned if it might impact upon an attorney's ability to relocate to a new firm after another's dissolution. In effect there is one body of law governing the inter-se rights of law firm partners and another body of law governing the inter-se rights in non-law partnerships. Except, of course, there is not a separate organizational form for law partnerships versus other partnerships; UPA §§ 18(f) and 30 are the law of New York for all partnerships.

Fourth, the Court's reasoning that the attorney's attention on client matters should not be limited by financial obligations to former partners and the old firm is not by its terms limited to

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[64] Model Rules of Prof'l Conduct R. 1.10 (2013) (The degree to which the new firm may "Chinese wall" the lateral attorney so as to avoid tainting the new firm will be dependent upon the workings of the state adoption of ABA Rule 1.10 or a similar rule.).

[65] *See also* Richmond, *Migratory Law Partners*, *supra* note 9, at 418 ("Regarding the lock-out problem, there is similarly no evidence that it exists.")

that factual situation. Rather, by placing the interest of the client in a position superior to the partner's inter-se agreement, the client is afforded the right to dictate the partnership's disposition of the fees it pays. To that end, a client desiring that they receive the particular attention of a particular attorney could insist that the sharing ratio on those fees be altered in that attorney's favor. While it cannot be suggested that this is what the *Thelen* Court intended, this outcome is the logical application of its weighting of interests between the firm and the client.

Last, the question of a property interest in the file is a red herring.[66] While neither the firm nor an attorney thereat may not have an enforceable property interest in the client's file, the firm does have an enforceable property interest in the proceeds of the attorney's work with respect thereto. The *Thelan* Court failed to recognize (or grant any credence to) this distinction. Rather it conflated the absence of an enforceable possessory interest in the file with the lack of a possessory interest in the attorney fees generated therefrom.[67] In joining a firm and undertaking work on a particular file, an attorney commits that those proceeds in the form of attorney fees will be remitted to the firm and shared amongst its partners in accordance with the partnership agreement and, where the partnership agreement is silent, the underlying partnership law.[68]

CONCLUSION

New York is the home of *Meinhard v. Salmon*[69] and its lofty direction that:

> Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the marketplace. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.[70]

In re Thelen and *In re Coudert Brothers* constitute an abandonment of this standard, providing in effect that the "punctilio of an honor" does not apply where a third-party to the inter-partner relationship might arguably be impacted thereby. Rather, notwithstanding that the partnership "continues" through dissolution,[71] the New York Court of Appeals has decreed that partners are free to seek to move existing engagements to new firms and uniquely capture for themselves the benefits of work performed for that client, including work that is but a continuation of work pending at the time of the prior firm's dissolution. While those who

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[66] *See* Rogers, *supra* note 30.

[67] *See also* Debra Cassens Weiss, *Two Duane Morris partners resign after malpractice suit alleges their own LLC collected fees*, ABA JOURNAL (March 31, 2015, 8:14 AM). http://www.abajournal.com/news/article/two_duane_morris_partners_resign_after_malpracticesuit_alleges_their_own_ll (reporting on alleged scheme whereby attorneys directed client to pay fees not to the firm but to an LLC apparently owned by the two attorneys).

[68] *See also Ellerby v. Spiezer*, 485 N.E.2d at 416, *supra* note 41.

[69] 164 N.Y.S.2d 545 (N.Y. 1928).

[70] *Id*. at 546 (N.Y. 1928).

[71] *See* UNIF. P'SHIP ACT § 30, 6 (pt. II) U.L.A. 354 (2001); N.Y. P'SHIP ACT § 61; TEX. BUS. ORGS. CODE § 152.701(1) (West 2012).

would advance and benefit from a mercenary view of attorneys (a too broadly held view in society generally) may laud the *Thelen* and *Coudart* decisions, it in a sad departure in the law for those who believe inter-partner obligations have enforceable meaning.

DISSIDENT DIRECTOR WHO HARMS CORPORATION TO FURTHER PERSONAL OBJECTIVES VIOLATES DUTY OF LOYALTY

Byron F. Egan

I. Director Duty of Loyalty

Directors owe fiduciary duties to a corporation on whose Board of Directors ("*Board*") they serve and effectively to all of its stockholders.[1] The fiduciary duty of loyalty dictates that directors act in good faith and not allow their personal interests to prevail over those of the corporation.[2] Thus, a director may not use confidential company information, or disclose it to third parties, for personal gain without authorization from his fellow directors.[3] This principle is often memorialized in corporate policies.[4]

II. Duty of Loyalty Breached by Leaking Confidential Information

In *Shocking Technologies, Inc. v. Michael*,[5] a director ("*Michael*") of a privately held Delaware corporation in dire financial straits who was on the Board as the representative of two series of preferred stock, was sued by the corporation for breaching his duty of loyalty by leaking negative confidential information to another preferred shareholder considering an additional investment in the company. The Delaware Court of Chancery found that Michael disclosed the confidential information (i) to encourage the potential investor to withhold funds the corporation desperately needed, thereby making the company accommodating to the governance changes sought by Michael, or (ii) if the investor nevertheless decided to invest, to help the investor get a "better deal" which would include Board representation for such investor (thereby changing the balance of power on the Board in Michael's favor).[6] In holding that Michael had violated his duty of loyalty, the Chancery Court explained:

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[1] Byron F. Egan, *How Recent Fiduciary Duty Cases Affect Advice to Directors and Officers of Delaware and Texas Corporations*, University of Texas School of Law 35th Annual Conference on Securities Regulation and Business Law, Austin, TX, Feb. 8, 2013, http://www.jw.com/publications/article/1830.

[2] Gearhart Indus., Inc. v. Smith Int'l., Inc., 741 F.2d 707, 719 (5th Cir. 1984); Kahn v. Kolberg Kravis Roberts & Co., L.P., 23 A.3d 831 (Del. 2011); Solash v. Telex Corp., 1988 WL 3587, at *7 (Del. Ch. 1988).

[3] Hollinger Intern., Inc. v. Black, 844 A.2d 1022, 1062 (Del Ch., 2004); Agranoff v. Miller, 1999 WL 219650, at *19 (Del. Ch. Apr. 12, 1999), aff'd as modified, 737 A.2d 530 (Del. 1999).

[4] *See* Disney v. Walt Disney Co., C.A. No. 234-N, 2005 Del. Ch. LEXIS 94, at *11-14 (Del. Ch. June 20, 2005) (discussing a written confidentiality policy of The Walt Disney Company that bars present and former directors from disclosing information entrusted to them by reason of their positions, including information about discussions and deliberations of the Board). *See* The Walt Disney Company Code of Business Conduct and Ethics for Directors, http://thewaltdisneycompany.com/content/code-business-conduct-and-ethics-directors.

[5] C.A. No. 7164-VCN (Del. Ch. Oct. 1, 2012), http://courts.delaware.gov/opinions/download.aspx?ID=179010.

[6] *Id.* at 26–28.

> The fiduciary duty of loyalty imposes on a director "an affirmative obligation to protect and advance the interests of the corporation" and requires a director "absolutely [to] refrain from any conduct that would harm the corporation". Encompassed within the duty of loyalty is a good faith aspect as well. "To act in good faith, a director must act at all times with an honesty of purpose and in the best interest and welfare of the corporation." **A director acting in subjective good faith may, nevertheless, breach his duty of loyalty. The "essence of the duty of loyalty" stands for the fundamental proposition that a director, even if he is a shareholder, may not engage in conduct that is "adverse to the interests of [his] corporation**."[7] [Emphasis added]

The *Shocking Technologies* case involved a dissident director who was the sole Board representative of two series of preferred stock. Over time, significant disagreements between Michael and the other Board members arose over executive compensation and whether there should be increased Board representation for the preferred stock. Michael argued that the company's governance problems would need to be resolved before it could attract additional equity funding. The other directors believed, however, that these disagreements were a pretext for Michael's desire to increase his influence and control over the Board at a time when the company faced financial difficulties.[8]

As the disagreements escalated, Michael contacted another holder of preferred stock who represented the company's only remaining source of capital to discourage the holder from exercising its warrants to purchase additional shares of the company's stock.[9] Michael also told the potential investor that the company was in a dire financial situation, that the investor was the only present source of financing, and that the investor should use this leverage to negotiate for more favorable terms, such as a lower price or Board representation.[10] The court found that Michael shared this confidential information with the potential investor because Michael anticipated that he would be more likely to achieve his goals if the investor either (i) withheld any additional investment in the company, thereby leaving the company desperate for funding,[11] or (ii) used the confidential information to get better deal terms, which Michael believed would undercut the authority of the balance of the Board.

In rejecting Michael's argument that his efforts were intended to "better the corporate governance structure" of the company and "reduce [the CEO's] domination" of the Board, the court wrote:

> Michael may, for some period of time, have been motivated by idealistic notions of corporate governance. It was no doubt convenient that his corporate governance

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[7] *Id.* at 21–22.

[8] *Id.* at 4–5.

[9] *Id.* at 14.

[10] *Id.*

[11] The company alleged that Michael was seeking to force the company into a new down round share issuance in which Michael could purchase shares on the cheap and dilute the other stockholders. *Shocking Technologies, Inc.*, C.A. No. 7164-VCN at 5.

> objectives aligned nicely with his self-interest.[12] When he and his fellow B/C [series of preferred stock] investors bought into Shocking, they did so knowing that they collectively only had one out of six board slots. Apparently, Michael came to regret that decision and worked to avoid the deal that he made. He contrasted the one out of six board seats designated by the B/C investors with B/C investors' substantial shares of all funds invested in Shocking.[13] That disparity annoyed him, but it was the board representation which he negotiated. In the abstract, his argument that board representation should be more proportional to investment is plausible. To describe it as a matter of good corporate governance—something that he may have believed or rationalized in contravention of the investment commitments that he made—strikes an observer from a distance as somewhere between disingenuous and self-righteous self-interest.
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> * * *
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> Regardless of how one might prioritize Michael's corporate governance concepts, those objectives would not justify pushing the Company to the brink of—or beyond—a debilitating cash shortfall. It is not an act of loyalty for a director to seek to impose his subjective views of what might be better for the Company by exercising whatever power he may have to threaten the Company's survival. In short, even if Michael had reasonable goals, he chose improper means, including disclosure of confidential information, in an attempt to achieve them.
>
> Michael's conduct had a foreseeable (and intended) consequence: depriving the Company of a cash infusion necessary for its short-term survival. It turns out that a predictable result of his actions did not occur. In these circumstances, a director may not put the existence of a corporation at risk in order to bolster his personal views of corporate governance. The lesson to be learned from these facts must be carefully confined, however. First, fair debate may be an important aspect of board performance. A board majority may not muzzle a minority board member simply because it does not like what she may be saying. Second, criticism of the conduct of a board majority does not necessarily equate with criticism of the corporation and its mission. The majority may be managing the business and affairs of the corporation, but a dissident board member has significant freedom to challenge the majority's decisions and to share her concerns with other shareholders. On the other hand, internal disagreement will not generally allow a dissident to release confidential corporate information. Fiduciary obligations are shaped by context. A balancing of the various conflicting factors will be necessary, and sometimes the judgments will be difficult. Here, the most logical objective of Michael's actions—strangling the Company with a potentially catastrophic cash shortfall—cannot be reconciled with his

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[12] *See* City Capital Assocs. Ltd. P'ship v. Interco. Inc., 551 A.2d 787, 796 (Del. Ch. 1988) ("human nature may incline *even one acting in subjective good faith* to rationalize as right that which is merely personally beneficial").

[13] Michael believed that the B/C series investors had contributed 70% of the capital paid in to the company. *Shocking Technologies, Inc.*, C.A. No. 7164-VCN at 26 n.57.

"unremitting" duty of loyalty. Thus, Michael did breach his fiduciary duty of loyalty to Shocking.[14]

III. Director Debate Has Limits

The court recognized that the crucible of director debate can be good for the corporation, albeit frustrating to the protagonists:

> Shareholders and directors, sometimes to the chagrin of a majority of the board of directors, may seek to change corporate governance ambiance and board composition. That is not merely permitted conduct; such efforts may be entitled to affirmative protection as part of the shareholder franchise. Michael's objectives as to his corporate governance agenda were not proscribed. They may have been prudent, or they may have been irresponsible. Nonetheless, it was his right to make such policy choices.
>
> The steps that a shareholder-director may take to achieve objectives are not without limits. A director may not harm the corporation by, for example, interfering with crucial financing efforts in an effort to further such objectives. Moreover, he may not use confidential information, especially information gleaned because of his board membership, to aid a third party which has a position necessarily adverse to that of the corporation.[15]

The court in *Shocking Technologies*, however, found that the director went too far in pursuing his objective by his disclosure of confidential information to a third party dealing with the corporation:

> Michael may have hoped that his disclosure of confidential information to Dickinson [the investor] would have ultimately resulted in better corporate governance practices for Shocking [the corporation]. That hope, however, cannot outweigh or somehow otherwise counterbalance the foreseeable harm that he would likely cause Shocking. Notwithstanding his good intentions, his taking steps that would foreseeably cause significant harm to Shocking amounts to nothing less than a breach of the fiduciary duty of loyalty.[16]

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[14] *Shocking Technologies, Inc.*, C.A. No. 7164-VCN at 25–28.

[15] *Id.* at 23; *Cf.* Sherwood v. Chan Tze Ngon, 2011 Del. Ch. LEXIS 202, *25-26 (Del. Ch. Dec. 20, 2011), which involved an action over disclosures about a Board's decision not to renominate a director for election at the company's annual meeting, and in which the court found that the plaintiff had adequately alleged disclosure claims where the proxy statement suggested that the director's "questionable and disruptive personal behavior was the only reason that motivated the board to remove him from the Company's slate." The court commented that it is "important that directors be able to register effective dissent" and that "[a] reasonable shareholder likely would perceive a material difference between, on the one hand, an unscrupulous, stubborn and belligerent director as implied by the Proxy Supplement and, on the other hand, a zealous advocate of a policy position who may go to tactless extremes on occasion."

[16] *Shocking Technologies, Inc.*, C.A. No. 7164-VCN at 24.

The court, however, did not award damages to the corporation as it did not find that there were any material damages suffered by the corporation and found that the director did not manifest the "subjective bad faith" required for an award of attorney's fees to the corporation.[17] The court appeared concerned that shifting fees may be too much of a penalty for a dissident director, and may make it too easy for the majority to use as a "hammer" to silence those members of the Board who dissent, explaining: "The line separating fair and aggressive debate from disloyal conduct may be less than precise."[18]

IV. Lessons from *Shocking Technologies*

The *Shocking Technologies* case illustrates the risk that a director takes when he leaks confidential information to achieve his objectives, however laudable he may believe them to be. The case also shows the difficulties corporations face when dealing with directors who will take steps that may damage the corporation to achieve their personal objectives.

[17] *Id.* at 33

[18] *Id.* at 34

PICK YOUR PARTNER VERSUS THE UNITED STATES BANKRUPTCY CODE

By Herrick K. Lidstone, Jr.[*]
and
Allen Sparkman[**]

Unincorporated Entities and the Pick Your Partner Principle

Partnership law from the beginning contained provisions implementing what has come to be known as the "pick your partner" principle, reflecting the early development of the partnership law provision that admission of a partner to a partnership requires unanimous consent of the partners.[1] As limited partnership and limited liability company statutes developed, the pick your partner principle was embodied in those statutes.[2] The Colorado, Delaware, and Texas limited liability company statutes provide that the interest a member has in a limited liability company is personal property and, subject to agreement, may be assigned.[3] These same provisions, however, also state that, absent agreement otherwise, the assignee only receives the assignor's rights to profits and losses and distributions and does not receive any rights to participate in management.[4]

- Colorado and Delaware provide that a member ceases to be a member upon the assignment of all of the member's membership interest,[5] whether or not the assignee becomes a member.[6]

- By contrast, Texas law provides that the "assignor continues to be a member and is entitled to exercise any unassigned rights or powers of a member of the

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[1] Daniel S. Kleinberger, *The Plight of the Bare Naked Assignee*, 42 Suffolk U. L. Rev. 587, 589–90 (2009). The authors express their appreciation to Professor Kleinberger (William Mitchell College of Law) for his thoughtful review of this article.

[2] Professor Kleinberger (*op. cit.* n. 1) notes that the inclusion of the pick your partner principle in limited liability company statutes enables an entity that in some circumstances looks very corporate to impose restrictions on transfers and assignees that go well beyond what would be permitted under corporate law. *Id*. at 597.

[3] COLO. REV. STAT. § 7-80-702(1) (2015); DEL. CODE ANN. tit. 6, §§ 18-701, 18-702(a), (b)(1) (2014); TEX. BUS. ORGS. CODE § 101.108. (2015).

[4] COLO. REV. STAT. § 7-80-702(1); DEL. CODE ANN. tit. 6, §§ 18-701, 18-702(a), (b)(1); TEX. BUS. ORGS. CODE § 101.108.

[5] "Membership interest" ("Limited liability company interest" in Delaware) is defined as the member's economic rights and does not include governance rights. COLO. REV. STAT. § 7-80-102(10); DEL. CODE ANN. tit. 6, § 18-101(8). The Texas Business Organizations Code defines membership interest with respect to a limited liability company as including "a member's share of profits and losses or similar items and the right to receive distributions, but does not include a member's right to participate in management." TEX. BUS. ORGS. CODE § 1.002(54).

[6] COLO. REV. STAT. § 7-80-702(1), (2); DEL. CODE ANN. tit. 6, § 18-702(b)(3). Texas defines membership interest with respect to a limited liability company as including "a member's share of profits and losses or similar items and the right to receive distributions, but does not include a member's right to participate in management." TEX. BUS. ORGS. CODE § 1.002(54).

company until the assignee becomes a member."[7]

The Texas provision may be viewed as an extreme consequence of the pick your partner doctrine and, in most cases, should be addressed in the LLC's operating agreement, or the company may find itself with a large part of the voting power of its interests being exercisable by persons who no longer have an economic stake in the company.

Similar provisions are found in the Colorado,[8] Delaware,[9] and Texas[10] partnership and limited partnership statutes and are expanded in many, if not most, LLC operating agreements and partnership agreements. The authors believe that the policy behind these statutory "pick your partner" provisions is sound since,[11] in creating or restructuring a business as a closely

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[7] TEX. BUS. ORGS. CODE § 101.111(a).

[8] *See* COLO. REV. STAT. § 7-64-502 (partner's transferable interest is personal property; § 7-64-503 (partner's transferable interest is assignable but does not entitle the assignee to participate in management or conduct of the partnership's business or access to the partnership's books and records); §§ 7-62-701, -702, -704 (limited partnership statute provisions same as partnership statute). Article 64 of the Colorado Revised Statutes is Colorado's enactment of the Revised Uniform Partnership Act and is applicable to partnerships formed on or after January 1, 1998. *See* COLO. REV. STAT § 7-64-107 (2015). Article 60 of the Colorado Revised Statutes is Colorado's enactment of the Uniform Partnership Act (1914). *See* COLO. REV. STAT § 7-60-101. There are still many existing partnerships that were formed under Article 60. § 7-60-118(1)(g) provides that "[n]o person can become a member of a partnership without the consent of all the partners." *Id.* Section 7-60-127(1) provides that "[a] conveyance by a partner of the partner's interest in the partnership . . . merely entitles the assignee to receive in accordance with the assignee's contract the profits to which the assigning partner would otherwise be entitled." *Id.* Section 7-60-129 defines "dissolution of a partnership" to be "the change in the relation of the partners caused by any partner ceasing to be associated in the carrying on . . . of the business." *Id.* Finally, § 7-60-131(1)(e) provides that "[d]issolution is caused . . . (e) By the bankruptcy of any partner or the partnership." *Id.*

[9] *See* DEL. CODE ANN. tit. 6, § 15-502 ("A partnership interest is personal property. Only a partner's economic interest may be transferred."); § 15-503(a)(2), (3) (no right to participate in management or to inspect books and records); § 15-503(b)(3) (transferee may seek "a judicial determination that it is equitable to wind up the partnership business or affairs"); § 17-701 ("A partnership interest is personal property"); § 17-702(a)(2) (transferee has no rights as partner); § 17-702(a)(4) (partner ceases to be a partner upon assignment of all of the partner's partnership interest).

[10] *See* TEX. BUS. ORGS. CODE § 1.002(68) ("'Partnership interest' . . . includes the partner's share of profits and losses or similar items and the right to receive distributions. The term does not include a partner's right to participate in management."); § 152.401 (partnership interest is transferable); § 152.402(3) (transferee has no right to participate in the management or conduct of the partnership's business); § 152.403 ("The transferor continues to have the rights and duties of a partner other than the interest transferred."); § 152.404(d) ("For a proper purpose the transferee may require reasonable information or an account of a partnership transaction and make reasonable inspection of the partnership books. In a winding up of partnership business, a transferee may require an accounting only from the date of the latest account agreed to by all of the partners."); § 153.251(a) (partnership interest is assignable); § 153.251(b)(2) (assignee not entitled to become a partner or to exercise the rights or powers of a partner); § 153.252(a) (assignor continues to be a partner in the limited partnership "until the assignee becomes a partner" and assignor "may exercise any rights or powers of a partner, except to the extent those rights or powers are assigned"); § 153.252(b) ("[O]n the assignment by a general partner of all of the general partner's rights as a general partner, the general partner's status as a general partner may be terminated by the affirmative vote of a majority-in-interest of the limited partners.").

[11] Indeed, a comment to Section 502 of the Revised Uniform Limited Liability Company Act states that "one of the most fundamental characteristics of LLC law is its fidelity to the 'pick your partner' principle." REV. UNIF. LTD. LIAB. CO. ACT § 502 cmt. (2006). However, as is true in many cases of a generally sound policy, the rationale breaks down at the margin. In the case of a single-member LLC, there appears to be no reason to apply the pick your partner principle since the single member has no "partner." Likewise, the justification for the pick your partner principle is unclear, at best, in the case of widely-traded limited partnerships or LLCs where transferability may be expected.

held LLC or partnership entity, the owners often wish to restrict themselves and each other from transferring a membership interest in an LLC or a partnership interest without the consent of the other owners. State laws generally allow the owners of a business to pick their partners and maintain the partnership relationships. As discussed below, however, the impact of the U.S. Bankruptcy Code, when an owner (member or partner) files bankruptcy, may dramatically impact "pick your partner" and suggests careful drafting of the operative agreements.

What Are Membership Interests or Partnership Interests?

Ownership interests[12] in an LLC or a partnership are actually a collection of rights, which must be understood in the context of the entity statutes and the governing agreement. Unincorporated entity advisors will generally agree that a member's interest in a limited liability company or a partner's interest in a partnership is comprised of the following:

- An interest in the income, loss, gain, credits, distributions, tax allocations, and other financial attributes of the LLC or partnership ("Economic Rights");

- Certain ownership rights available only to persons who have been admitted as members of the LLC or partners of the partnership, including the right to inspect records, bring derivative actions, to notice of meetings of the owners and to vote on matters presented to the owners ("Owner's Rights"); and

- Certain rights to actually manage or operate the business that may be attributable to the manager of a manager-managed LLC, the managing member of a member-managed LLC, the general partner of a limited partnership, or the managing partner of a general partnership ("Management Rights").

These rights are defined by the limited liability company's operating agreement or the partnership agreement and other governing documents.[13] Many partnership agreements and operating agreements have provisions that restrict transfers of an interest in the entity unless the agreement's requirements are followed.[14] These requirements may include a right of first

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[12] Ownership interests in an LLC or partnership can be referred to by the governing statutes in a number of ways. Delaware refers to the ownership interest in an LLC as a "limited liability company interest," whereas Colorado and Texas both refer to it as a "membership interest." DEL. CODE ANN. tit. 6, § 18-101(8); COLO. REV. STAT. § 7-80-102(10); TEX. BUS. ORGS. CODE § 1.002(54). This article will use the reasonably common terms "membership interest" for an ownership interest in an LLC and "partnership interest" for an ownership interest in a partnership, consistent with Colorado, Delaware, and Texas law. Governing documents for an LLC or a partnership should be drafted using terms that are consistent with the applicable governing statute.

[13] It is important to note that where the operating agreement, partnership agreement, or other governing documents are incomplete, the default rules of the applicable statute will fill in any gaps. It is likely that the default rules will seldom be satisfactory as a matter of business judgment.

[14] The following is a simple provision prohibiting transfer except to existing members of an LLC: "Should any Member or Assignee attempt to sell, transfer, assign, or in any way alienate all or any portion of his Economic Interest by charging order against the Member or Assignee, or otherwise ('Transferred Interest') to a Person not then a Member, whether now owned or hereafter acquired, without the prior written consent of the Managers (whether such transfer is voluntary or involuntary, by operation of law, by court order, by charging order, or otherwise), such attempted sale, transfer, assignment, or other form of alienation shall be deemed to be void *ab initio*, and this shall be considered to be a 'Terminating Event' unless it is accomplished in accordance with the procedures outlined in this

refusal in the other owners or the entity itself and a repurchase right for transfers that violate the agreement's restrictions. These protect the remaining owners from voluntary or even involuntary transfers by an owner, such as in a divorce proceeding where the court orders one-half of the interest be transferred to a spouse,[15] or in a charging order proceeding where the creditor of the member or partner seeks foreclosure of the charging order. Divorce statutes and charging order statutes are products of state law and would be subject to the procedure for foreclosure against a personal property interest.[16]

The state law "pick your partner" rules, as implemented and expanded in many operating agreements and partnership agreements, are intended to prohibit or penalize a member or partner who conveys the member's or partner's interest, whether the conveyance is voluntary or involuntary. In most cases, at best the assignee would be treated as holding Economic Rights without the Owner's Rights or Management Rights of a member or partner.

Arguably, a transfer of the Economic Rights alone does not upset the "pick your partner" principle. Were a member or partner to transfer the Owner's Rights or Management Rights to a stranger, however, the remaining owners would be saddled with a new partner holding the Owner's Rights and Management Rights, and the stranger may not have short- or long-term views that are compatible with those of the remaining owners. Where, as in Texas, an owner can transfer the Economic Rights while retaining the Owner's Rights and Management Rights, ownership becomes divorced from decision-making—again placing the remaining owners in an unexpected situation.

The Uniform Commercial Code Is Not Supportive of "Pick Your Partner"

In state law, Article 9 of the Uniform Commercial Code has provisions that may be inconsistent with the "pick your partner" principles of the partnership and limited liability company acts. Section 9-408(a) as enacted in many states, including Colorado, provides in part,

> Except as otherwise provided in subsection (b), a term in . . . an agreement between an account debtor and a debtor which relates to a . . . general intangible,[17] including

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Article IX," which usually involve a right of first refusal, manager (or member) approval, and treatment of the assignee as merely an economic interest holder unless admitted to the LLC as a member. *See* HERRICK K. LIDSTONE, JR. & ALLEN SPARKMAN, LIMITED LIABILITY COMPANIES AND PARTNERSHIPS IN COLORADO §§ 3.1.8–.9 (CLE in Colorado, Inc., 2015).

[15] Note that in Texas a membership interest or partnership interest may be community property. TEX. BUS. ORGS. CODE § 101.106(a-1) (A membership interest may be community property under applicable law). However, "a member's right to participate in the management and conduct of the business of the limited liability company is not community property." § 101.106(a-2); § 154.001(b) ("A partner's partnership interest may be community property under applicable law.").

[16] In September 2014, the South Carolina Supreme Court ruled that a foreclosure sale was valid and trumped the operating agreement's repurchase right, and that the repurchase right could not be enforced. Levy v. Carolinian, LLC, 763 S.E.2d 594, 597–98 (S.C. 2014). See discussion in Doug Batey, *South Carolina Supreme Court Invalidates LLC Operating Agreement's Repurchase Right After Charging Order Foreclosure*, LLC Law Monitor (Sept. 15, 2014), http://www.llclawmonitor.com /2014/09/articles/charging-orders/south-carolina-supreme-court-nvalidates-llc-operating-agreements-repurchase-right-after-charging-order-foreclosure/.

[17] The term "general intangible" is defined in section 9-102(a)(42) to mean: "any personal property" with

> a contract, permit, license, or franchise, and which term prohibits, restricts, or requires the consent of the person obligated on the . . . account debtor to, the assignment or transfer of, or creation, attachment, or perfection of a security interest in, the . . . general intangible, is ineffective to the extent that the term:
>
> (1) would impair the creation, attachment, or perfection of a security interest; or
>
> (2) provides that the assignment or transfer or the creation, attachment, or perfection of the security interest may give rise to a default, breach, right of recoupment, claim, defense, termination, right of termination, or remedy under the . . . general intangible.[18]

Sections 4-9-406, 4-9-408 and 4-9-409 of the Uniform Commercial Code (as enacted in Colorado) have similar provisions relating to promissory notes, health care receivables, chattel paper, payment intangibles, accounts, letters of credit, and other general intangibles, both in the assignability of the ownership and the creation of a security interest in the ownership interest.[19] Colorado has preserved the primacy of the "pick your partner" principle for limited liability companies, partnerships, and other entities by providing the following exemption from the Uniform Commercial Code: "Sections 4-9-406 and 4-9-408, C.R.S. shall not apply to an owner's interest."[20] Delaware and Texas have enacted similar provisions exempting partnership and limited liability company interests from the application of sections 4-9-406 and 4-9-408 of the Uniform Commercial Code.[21] Attorneys drafting an LLC or partnership agreement should be cognizant of the potential impact on these and similar statutory exemptions of a choice of law provision in the agreement.

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exceptions not applicable here. U.C.C. § 9-102(a)(42) (AM. LAW INST. & UNIF. LAW COMM'N 2010). As discussed earlier, *see* discussion *supra* notes 3, 8–10 and accompanying text, state limited liability company and partnership statutes define a member or partner's interest as "personal property." *E.g.*, COLO. REV. STAT. § 7-80-702(1); DEL. CODE ANN. tit. 6, §§ 18-701, 18-702(a), (b)(1); TEX. BUS. ORGS. CODE § 101.108.

[18] U.C.C. § 9-408(a) (AM. LAW INST. & UNIF. LAW COMM'N 2010).

[19] COLO. REV. STAT. §§ 4-9-406, -408, -409 (2015).

[20] COLO. REV. STAT. § 7-90-104. The term "owner's interest" is broadly defined in section 7-90-102(44) to include "shares of stock in a corporation, a membership in a nonprofit corporation, a membership interest in a limited liability company, the interest of a member in a cooperative or in a limited cooperative association, a partnership interest in a limited partnership, a partnership interest in a partnership, and the interest of a member in a limited partnership association." *Id.*

[21] DEL. CODE ANN. tit. 6, §§ 15-104(c) (partnerships), 17-1101(g) (limited partnerships), 18-1101(g) (limited liability companies); TEX. BUS. ORGS. CODE §§ 101.106(c) (limited liability companies), 154.001(d) (partnerships and limited partnerships).

Unincorporated Entities and Bankruptcy[22]

If a member or partner files for bankruptcy, the "pick your partner" principle may be applied in uncertain ways and may, in fact, be ignored. Bankruptcy is a matter of federal law[23] and may override state law and any "pick your partner" provisions found in the operating agreement or the partnership agreement.

Property of The Estate

Consider a member of a multi-member limited liability company who files for bankruptcy protection either in liquidation (under Chapter 7) or for a reorganization (under Chapter 11 or, for a consumer debtor, Chapter 13). Section 541(a)(1) provides,

> (a) The commencement of a case under section 301, 302, or 303 of this title creates an estate. Such estate is comprised of all the following property, wherever located and by whomever held: (1) Except as provided in subsections (b) and (c)(2) of this section [541], all legal or equitable interests of the debtor in property as of the commencement of the case.[24]

By operation of law, therefore, the filing of the bankruptcy petition creates an estate, which includes the owner's interest in an LLC or partnership.[25] The bankruptcy estate may be managed by a third-party trustee (under Chapter 7) or the debtor in possession (under Chapters 11 and 13).[26] This is a transfer which arguably should be subject to the "pick your partner" limitations except for the pre-eminency of bankruptcy law.[27]

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[22] The authors express their gratitude for the review of the bankruptcy discussion in this article by Kyung S. Lee, a partner in the Houston office of Diamond McCarthy LLP and Deanna L. Westfall, a partner in the Denver office of Weinstein & Riley, P.S.

[23] 11 U.S.C § 101 (2012).

[24] 11 U.S.C. § 541(a)(1).

[25] 11 U.S.C. § 541(a) (2012). Section 541(a) has five additional clauses that are equally expansive, intending to capture anything the debtor owns at the filing date or has a right to acquire as of the filing date. § 541(a)(1)–(5).

[26] *See* 11 U.S.C. § 542(a) (2012). Section 1107 of the Bankruptcy Code places the debtor in possession in the position of a fiduciary, with the rights and powers of a chapter 11 trustee. 11 U.S.C. § 1107(a) (2012). When used herein, the term "trustee" includes the debtor in possession.

[27] The Delaware limited liability company act provides that a member ceases to be a member upon filing a bankruptcy petition. DEL. CODE ANN. tit. 6, § 18-304(1)b (2015). Similarly, a partner of a Delaware or Texas general partnership ceases to be a partner if the partner becomes a debtor in bankruptcy. DEL. CODE ANN. tit. 6, § 15-601(6) (2015); TEX. BUS. ORGS. CODE § 152.501.501(b)(6)(A) (2015). These Delaware and Texas provisions will likely be disregarded under Section 541(c)(1)(B) of the Bankruptcy Code. *See In re* Garbinski, 465 B.R. 423, 426–27 (Bankr. W.D. Pa. 2012) (Citing *In re* First Protection, Inc., 440 B.R. 821, 830 (B.A.P. 9th Cir. 2010); *In re* Prebul, 2011 Bankr. LEXIS 2795, 2011 WL 2947405 (Bankr. E.D. Tenn. 2011); *In re* Dixie Management & Inv. Ltd. Partners, 2011 Bankr. LEXIS 1686, 2011 WL 1753971 (Bankr. W.D. Ark. 2011); *In re* Daugherty Construction, Inc., 188 B.R. 607 (Bankr. D. Neb. 1995) ("The cases are pretty clear that Section 541(c)(1) acts to override any provision of state law that would otherwise limit or restrict a trustee with respect to a debtor's limited liability or limited partnership interests. In other words, any attempt to invoke state law to treat a trustee as a mere 'assignee,' who does not enjoy any management rights in the LLC or partnership entities, fails as a result of Section 541(c)(1).").

Section 541(c)(1) of the Bankruptcy Code[28] provides that property of the debtor becomes property of the debtor's bankruptcy estate notwithstanding any transferability restrictions[29] or any provision "that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title, or on the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement."[30]

Section 541(c)(1) refers to any interest of the debtor in property—it does not limit the interest to the debtor's "Economic Rights" or "rights to a distribution." Even where a partnership or a limited liability company has attempted to separate the Economic Rights from Owner's Rights as contemplated in the respective "pick your partner" statutes or agreement provisions, § 541(c)(1) says "no."[31] Consequently, the trustee of the bankruptcy estate moves directly into the shoes of the debtor and retains the Owner's Rights[32] of the debtor in the LLC or partnership in addition to Economic Rights notwithstanding any transferability restriction or other agreement or law to the contrary.[33]

Any effort to dissociate the trustee (or the debtor) from the limited liability company or partnership would likely be found to violate the automatic stay that is imposed under 11 U.S.C. § 362.[34] Section 362(a)(3) prohibits "any act to obtain possession of property of the estate or of

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[28] Section 541(c)(1) provides as follows:

> Except as provided in paragraph (2) of this subsection, an interest of the debtor in property becomes property of the estate under subsection (a)(1), (a)(2), or (a)(5) of this section notwithstanding any provision in an agreement, transfer instrument, or applicable non-bankruptcy law -- (A) that restricts or conditions transfer of such interest by the debtor; or (B) that is conditioned on the insolvency or financial condition of the debtor, on the commencement of a case under this title, or on the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement, and that effects or gives an option to effect a forfeiture, modification, or termination of the debtor's interest in property. 11 U.S.C.S. § 541(c)(1) (2014).

[29] 11 U.S.C. § 541(c)(1)(A).

[30] 11 U.S.C. § 541(c)(1)(B).

[31] *See* § 541(c)(1)(A); Ebert v. DeVries Family Farm, LLC (*In re* DeVries), No. 11–43165–DML–7, 2014 WL 4294540, at *13 & n.93 (Bankr. N.D. Tex., Aug. 27, 2014) (quoting Butner v. United States, 440 U.S. 48, 55 (1979) ("Property interests are created and defined by state law."); Rine & Rine Auctioneers, Inc. v. Douglas Cty. Bank & Trust Co. (*In re* Rine & Rine Auctioneers, Inc.), 74 F.3d 854, 857 (8th Cir. 1996) (citing N.S. Garrot & Sons v. Union Planters Nat'l Bank of Memphis, (*In re* N.S. Garrott & Sons), 772 F.2d 462, 466 (8th Cir. 1985)) ("Once that state law determination is made, however, we must still look to federal bankruptcy law to resolve" the extent to which that interest is property of the estate)). This was also the conclusion reached by a Tennessee bankruptcy court in *In re* Denman, 513 B.R. 720, 727 (Bankr. W.D. Tenn. 2014).

[31] It is important to note that this does not necessarily apply to Management Rights. As discussed below, under § 365(e)(2) and § 541(c)(1)(B) of the Bankruptcy Code, the other members of the LLC will not be required to accept the trustee of the debtor's estate stepping into any management role of the debtor.

[33] *See* Klingerman v. ExecuCorp LLC (*In re* Klingerman), 388 B.R. 677, 679 (Bankr. E.D. N.C. 2008) (holding that debtor's "rights and interest in the LLC, economic and noneconomic, became property of the estate upon the filing of his petition"); *In re* Ellis, No. 10–16998–AJM–7A, 2011 WL 5147551, at *3 (Bankr. S.D. Ind. Oct. 27, 2011) (finding that the debtor retained both his economic and non-economic interest in the LLC when he filed his chapter 7 petition).

[34] *See* McCabe v. George Panagiotou & Gedco, LLC (*In re* McCabe), 345 B.R. 1, 7 (D. Mass. 2006) (holding that a non-debtor member amending a LLC agreement post-petition to reallocate the debtor's membership interest violates the automatic stay); *In re* Daugherty Const., Inc., 188 B.R. 607, 615 (Bankr. D. Neb. 1995) (concluding that LLC members voting post-petition to remove the debtor as manager and approving a new manager are actions that

property from the estate or to exercise control over property of the estate."[35] This issue arose in *Walro v. The Lee Group Holding Company, LLC*,[36] where the bankruptcy debtor was manager holding Management Rights and controlling member (with a 51% ownership and vote, Economic Rights and Owner's Rights) of an LLC (the Lee Group) at the time he filed bankruptcy. On the filing, the other members applied language of the operating agreement to treat the debtor as a non-voting assignee and acted to appoint a new manager. The chapter 7 trustee filed a complaint and a motion for summary judgment seeking reinstatement of the debtor's rights as a voting member (Owner's Rights) and sought the invalidation of the post-petition actions taken by the other members. After analyzing the operating agreement and Indiana law, the bankruptcy court granted the motion for summary judgment concluding that "Debtor was a member of the Lee Group as of the Petition Date and that Debtor's voting rights were conferred as an incident of that membership."[37] The court concluded that the debtor's voting rights were property of the estate under § 541(a) and that the action by the other members to remove those voting rights violated the automatic stay under § 363(a)(3).[38] The opinion in *Walro* does not discuss Section 365(e)(2) of the Bankruptcy Code[39] but states:

> By his Complaint, the Trustee did not seek to step into Debtor's shoes as manager, nor did he ask that the Court compel Debtor to remain as manager. In fact, the trustee has repeatedly and explicitly emphasized that he does not seek that type of relief. For that reason, the Court need not determine—at least in the context of this proceeding—whether the Code or relevant non-bankruptcy law supports either type of action.[40]

The Operating or Partnership Agreement and* Ipso Facto *Clauses.

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amount to "exercise of control over property of the estate and in violation of the automatic stay provisions" under 11 U.S.C. § 362((a)(3). The opinion does not discuss Section 365(e)(2) of the Bankruptcy Code, discussed *infra*, note 68 and accompanying text) . *But see In re* Garrison–Ashburn, 253 B.R. 700, 708–09 (Bankr. E.D. Va. 2000) (holding that an operating agreement is not an executory contract, and thus, because the Virginia LLC Act provided that a member became dissociated upon filing bankruptcy and thereafter had only the rights of an assignee, but dissociation of the member did not cause dissolution of the limited liability company, the bankruptcy estate had only the rights of an assignee despite Section 541(c)(1)). *Cf.* Nw. Wholesale, Inc. v. Pac Organic Fruit, LLC, 334 P.3d 63 (Wash. Ct. App. 2014) (Harold and Shirley Ostenson became 49% members of LLC in 1998, and the Ostensons filed for bankruptcy under Chapter 11 in 2007. Thereafter, the Ostensons brought a derivative action on behalf of the LLC. The court held that the Ostensons did not have standing to bring the derivative action because the Washington LLC statute provided that a member became dissociated with only the rights of an assignee upon filing a voluntary bankruptcy. The Ostensons relied on *In the Matter of Daugherty Const., Inc*. to support their contention that they retained membership and management rights in the LLC. The Washington court did not find *In the Matter of Daugherty Const., Inc.* persuasive because of the differences between the Washington and Nebraska LLC statutes. Because Washington law provides that a member's dissociation does not dissolve the LLC, and the dissociated member retains the member's economic rights, the court found the Washington statute to be similar to the Virginia LLC statute and adopted the reasoning of *In re Garrison-Ashburn*. *Id.* at 74-77.).

[35] 11 U.S.C. § 362(a)(3) (2012); *see also In re* Stinson, 221 B.R. 726, 730–31 (Bankr. E.D. Mich. 1998) (discussing that section 362(a)(3) is designed to prevent dismemberment of the bankruptcy estate and ensure the trustee has an opportunity to determine the rights and interest of the debtor in property).

[36] (*In re* Lee), 524 B.R. 798 (Bankr. S.D. Ind. 2014).

[37] *Id.* at 802.

[38] *Id.* at 804, ¶ 20.

[39] *See infra* note 68 and accompanying text.

[40] *In re* Lee, 524 B.R. at 805, ¶ 24.

Even though the bankruptcy estate takes the membership interest or partnership interest (and all Economic Rights and Owner's Rights) as property of the estate, the interest remains subject to governing law and the governing agreements. LLCs and partnerships are governed by the applicable statutes as well as by the governance contracts (usually referred to as "operating agreements"[41] and "partnership agreements"), which impose obligations on, and give certain rights to, members, partners, and assignees.

These contracts may include *ipso facto* provisions—provisions that are triggered by a person's financial condition or a bankruptcy filing. An *ipso facto* provision may be a provision that a member's bankruptcy filing constitutes the member's withdrawal from the LLC. A bankruptcy filing may trigger a buy-sell obligation. For example, the Delaware limited liability company act provides that a member ceases to be a member upon filing a voluntary bankruptcy petition.[42] A partner of a Delaware or Texas general partnership ceases to be a partner if the partner becomes a debtor in bankruptcy.[43] While these may be the case under the state statute and the governing agreements, these would be *ipso facto* clauses discussed below and likely unenforceable in bankruptcy where the trustee would step into the shoes of the debtor.

Section 365(e)(1) of the Bankruptcy Code provides that any provision in an executory contract, unexpired lease, or in applicable law (such as the Delaware and Texas statutes referenced above) that takes effect upon the appointment of a trustee, the commencement of a bankruptcy case, or "the insolvency or financial condition of the debtor at any time before the

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[41] In Texas, either a "company agreement" or "LLC agreement."

[42] DEL. CODE ANN. tit. 6, § 18-304(1)b (2014).

[43] DEL. CODE ANN. tit. 6, § 15-601(6) (2014); TEX. BUS. ORGS. CODE § 152.501(b)(6)(A) (2015). Interestingly, this issue did not exist under the Colorado Uniform Partnership Law, which is derived from § 29 of the Uniform Partnership Act (1914). As in the Uniform Partnership Act (1914), COLO. REV. STAT. § 7-60-131(1)(e) provides that dissolution of a partnership is caused "[b]y the bankruptcy of any partner or the partnership." COLO. REV. STAT. § 7-60-131(1)(e) (2006). Upon dissolution, the partner's bankruptcy trustee has the ability to extract the bankrupt partner's value from the partnership before allowing the remaining partners to re-commence the entity as a new partnership. *Id.*

The bankruptcy trustee cannot avail itself of the dissolution remedy under the more modern statutes. In the more modern partnership statutes, "bankruptcy" results in dissociation or withdrawal of the partner, not the dissolution of the partnership. *See* COLO. REV. STAT. § 7-64-601(1)(f)(I) (2006); DEL. CODE ANN. tit. 6, § 15-601(6)(b) (2005); TEX. BUS. ORGS. CODE § 152.501(b)(6)(A) (2012).

The LLC statutes also do not provide that bankruptcy of a member results in the dissolution of the LLC either specifically (as in DEL. CODE ANN. tit. 6, § 18-801(b) (2005), which specifically states that the filing of a bankruptcy by a member does not result in the dissolution of the LLC) or by not addressing the question at all (as in Colorado and Texas). Delaware law does provide that a member filing bankruptcy results in that person ceasing to be a member of an LLC formed under Delaware law. *See* § 18-304(1)(b).

Colorado does not address this question. Since the creation of the bankruptcy estate does not constitute an "assignment" or "transfer," the transferability provisions are not applicable, and consequently the provisions of COLO. REV. STAT. § 7-80-702(2) (2006) are inapplicable. That subsection states that "[a] member ceases to be a member upon assignment or transfer of all the member's membership interest." *Id.*

Texas also does not address the bankruptcy of a member of an LLC, although it states that "an assignor of a membership interest in a [LLC] continues to be a member of the company and is entitled to exercise any unassigned rights or powers of a member of the company [such as Owner's Rights and Management Rights to the extent not transferable] until the assignee becomes a member of the company." TEX. BUS. ORGS. CODE § 101.111(a) (2012). Thus the bankrupt member who may no longer have any Economic Rights will retain Owner's Rights.

closing of the [bankruptcy] case" is unenforceable.[44]

Section 541(c)(1)(B) goes beyond § 365 in that it applies to all of the property of the debtor, not just executory contracts which are the subject of § 365. This section provides that any interest of the debtor in property "becomes property of the estate notwithstanding any provision in an agreement, transfer instrument, or applicable nonbankruptcy law . . . that is conditioned on the insolvency or financial condition of the debtor . . . or taking possession by a trustee in a case under this title or a custodian before such commencement . . . ."[45]

Thus, provisions in state law or in operating agreements, partnership agreement, or other contracts that are conditioned on a person's bankruptcy or insolvency are not enforceable when that person files bankruptcy. As a result, LLC members and partners in a partnership who have carefully chosen their business partners may find themselves in business with a trustee that has different, and likely more short-term, goals than their former (now bankrupt) business partner.

Operating Agreements and Partnership Agreements As Executory Contracts.

Even though an LLC membership interest or partnership interest may be property of the bankruptcy estate, and *ipso facto* clauses are disregarded for that purpose, the examination of the operating agreement or partnership agreement does not end, and the court must look to other sections of the Bankruptcy Code to determine how such property must be treated.[46] Where a contract (operating agreement, partnership agreement, or other agreement) is an "executory contract," "the trustee, subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor."[47] In order to accept the benefits of an executory contract, the trustee must also be prepared to perform its obligations under the executory contract.[48]

The Bankruptcy Code defines when the trustee must accept an executory contract, and any executory contract not accepted within the mandated time period is deemed rejected. Section 365(d) provides that:

> (1) In a case under chapter 7 of this title, if the trustee does not assume or reject an executory contract or unexpired lease of residential real property or of personal property of the debtor within 60 days after the order for relief, or within such additional time as the court, for cause, within such 60–day period, fixes, then such contract or lease is deemed rejected.
>
> (2) In a case under chapter 9, 11, 12, or 13 of this title, the trustee may assume or reject an executory contract or unexpired lease of residential real property or of personal property of the debtor at any time before the confirmation of a plan but the court, on the request of any party to such contract or lease, may order the trustee to determine within a specified

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[44] 11 U.S.C. § 365(e)(1) (2012).

[45] *Id.* § 541(c)(1)(b) (2012).

[46] Bonneville Power Admin. v. Mirant Corp. (*In re* Mirant Corp.), 440 F.3d 238, 252 (5th Cir. 2006).

[47] 11 U.S.C. § 365(a) (2012).

[48] *See id.* § 365(b) (2012).

period of time whether to assume or reject such contract or lease.[49]

Section 365(g) provides that the rejection of an executory contract by the trustee constitutes a breach of the contract. By so stating, § 365(g) establishes "that in bankruptcy, as outside of it, the other party's rights remain in place" even after rejection.[50] "[R]ejection does not embody the contract-vaporizing properties so commonly ascribed to it. . . . Rejection merely frees the estate from being obligated to perform any future obligations"[51] under it, but the agreement has not disappeared. The operating agreement or partnership agreement (as applicable) still governs the bankruptcy estate's rights in the entity. Therefore, if the operating agreement or partnership agreement is an executory contract and if the trustee rejects that agreement, the court must look to the agreement itself to determine the effect of the rejection.

The Bankruptcy Code, however, does not define the term "executory contract."[52] Therefore, courts look to the "facts and circumstances of each case to determine the status of a particular operating agreement"[53] or partnership agreement. "Whether a contract is "executory" within the meaning of the Bankruptcy Code is a question of federal law."[54] The United States Supreme Court has stated that the legislative history of Section 365(a) indicates that Congress intended that an executory contract be defined as a contract "on which performance is due to some extent on both sides."[55] Many courts use the definition first proffered by Professor Vern Countryman in 1973:[56] "[A] contract is executory if 'the obligations of both parties are so far unperformed that the failure of either party to complete performance would constitute a material breach and thus excuse the performance of the

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[49] *Id.* § 365(d) (2012).

[50] Sunbeam Prods., Inc. v. Chi. Am. Mfg., LLC, 686 F.3d 372, 377 (7th Cir.2012). *See also In re* Hughes, 166 B.R. 103, 105 (Bankr. S.D. Ohio 1994) ("Consistent with the bankruptcy law's general deference to state-law rights in or to specific property, rejection of a contract does not terminate such rights that arise from rejected contracts. Rejection is not itself an avoiding power.").

[51] Thompkins v. Lil' Joe Records, Inc., 476 F.3d 1294, 1306 (11th Cir. Fla. 2007) (quoting Cohen v. Drexel Burnham Lambert Group, Inc. (*In re* Drexel Burnham Lambert Group, Inc.), 138 B.R. 687, 703 (Bankr. S.D.N.Y. 1992)).

[52] *Bildisco*, 465 U.S. at 522 n. 6 (quoting H.R. Rep. No. 95-595, p. 347 (1977).

[53] Meiburger v. Endeka Enters., L.L.C. (*In re* Tsiaoushis), 383 B.R. 616, 618 (Bankr. E.D. Va. 2007).

[54] Griffel v. Murphy (In re *Wegner*), 839 F.2d 533, 536 (9th Cir. 1988).

[55] *Bildisco*, 465 U.S. at 522 n.6 (quoting H.R. Rep. No. 95-595, p. 347 (1977)) (citing S. Rep. 95-989, p. 58 (1977)), superseded by statute, 11 U.S.C. § 1113 (2012); *see also* Griffel v. Murphy (*In re* Wegner), 839 F.2d at 536.

[56] Unsecured Creditors' Comm. of Robert L. Helms Const. & Dev. Co. v. Southmark Corp. (*In re* Robert L. Helms Const. & Dev. Co., Inc.), 139 F.3d 702, 705 (9th Cir. 1998) (quoting *Bildisco*, 465 U.S. at 522–23 (internal quotations omitted)). *See also,* Lewis Bros. Bakeries Inc. & Chicago Baking Co. v. Interstate Brands Corp. (*In re* Interstate Bakeries Corp.), 751 F.3d 955, 962 (9th Cir. 2014) ("This circuit has adopted Professor Countryman's definition of an executory contract for purposes of the Bankruptcy Code."); *See, e.g., In re* Exide Techs., 607 F.3d 957, 962 (3d Cir. 2010) ("With congressional intent in mind, this Court has adopted the [Countryman] definition."); Olah v. Baird (*In re* Baird), 567 F.3d 1207, 1211 (10th Cir. 2009) ("We therefore take this occasion to formally adopt the Countryman definition. . . ."); Lawson v. Lawson (*In re* Lawson), 14 F.3d 595 (4th Cir. 1993) ("The bankruptcy code does not define an executory contract, but the Fourth Circuit has adopted the generally accepted test for executoriness articulated by Professor Vern Countryman."); *In re* Crippin, 877 F.2d 594, 596 (7th Cir. 1989) (describing the Countryman test as "[a] common definition, which this court has cited with approval"); Nw. Airlines, Inc. v. Klinger (*In re* Knutson), 563 F.2d 916, 917 (8th Cir. 1977) (adopting the Countryman definition of an executory contract).

other.'"[57] Commentators have noted that:

> Although the Countryman definition has been widely adopted by the courts, it has not been universally adopted. Some courts have adopted the "functional approach," an approach that works backwards from an examination of the purposes to be accomplished by rejection and, if the purpose has already been accomplished, determines that the contract cannot be executory.[58]

The Fifth Circuit explained the functional approach as follows: "Section 365 derives from Sec. 70(b) of the former Bankruptcy Act, a provision that broadly codified the common law doctrine that allowed the trustee either to assume and perform the debtor's lease or executory contracts or to "reject" them if they were economically burdensome to the estate."[59]

The true nature of an executory contract is that it contains future performance obligations at least of the debtor.[60] These may include future obligations to guarantee debts, make capital contributions, perform services, or other future performance obligations. Unfortunately, as will become clear in the following examples, courts are not always clear in their analysis of operating agreements and partnership agreements when determining whether they are executory contracts and subject to § 365, or are not executory contracts and therefore property of the estate under § 541 and not subject to the § 365 assumption or rejection requirement.

For example, the Sixth Circuit Court of Appeals held that an executory contract as contemplated under § 365 must have "material obligations left to be performed by both parties to [a] contract."[61] *In re Ehmann* held that "a contract is executory if 'the obligations of both parties are so far unperformed that the failure of either party to complete performance would constitute a material breach and thus excuse the performance of the other.'"[62]

Courts have held that a contract is not executory if the only performance required by one side is the payment of money.[63] A contract that only imposes remote or hypothetical duties is

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[57] Vern Countryman, *Executory Contracts in Bankruptcy Part I*, 57 Minn. L. Rev. 439, 458–62 (1973) *quoted in In re* Ehmann, 319 B.R. 200, 203 (Bankr. D. Ariz. 2005).

[58] David M. Founier & John Henry Schanne, The Executory Contract Ride Through: A Doctrine from the Past Provides an Option for the Present, NORTON ANNUAL SURVEY OF BANKRUPTCY LAW 179, 183 (2009) , http://www.pepperlaw.com/resource/1237/27H1, (citing *In re* Magness, 972 F.2d 689, 694 (6th Cir. 1992). *See* Rieser v. Dayton Country Club Co. (*In re* Magness), 972 F.2d 689, 694 (6th Cir. 1992) (holding that the Countryman test "was found by this court to be helpful but not controlling in the resolution of what is an executory contract.") (citing Chattanooga Memorial Park v. Still (*In re* Jolly), 574 F.2d 349 (6th Cir. 1978)); Sipes v. Atl. Gulf Cmtys. Corp. (*In re* Gen. Dev. Corp.), 84 F.3d 1364, 1375 (11th Cir. 1996) ("While it does not appear that the Eleventh Circuit has adopted the "functional approach" over the "Countryman approach", the Eleventh Circuit ... appears more inclined to embrace the "functional approach.") (internal citations omitted).

[59] *In re* Austin Development Company, 19 F.3d 1077, 1081 (5th Cir. 1994).

[60] *See* cases cited *infra*, note 112.

[61] *In re* Terrell, 892 F.2d 469, 472 (6th Cir. 1989).

[62] *In re* Ehmann, 319 B.R. 200, 203-04 (Bankr. D. Ariz. 2005). *See also*, Phx. Exploration, Inc. v. Yaquinto (*In re* Murexco Petroleum, Inc.), 15 F.3d 60, 62-63 (5th Cir. 1994).

[63] Ocean Marine Servs. P'ship No. 1 v. Digicon, Inc. (*In re* Digicon, Inc.), 71 F. App'x 442, at *6 (5th Cir. 2003) (citing *In re* Placid Oil Co., 72 B.R. 135, 138 (Bankr. N.D. Tex. 1987)).

not an executory contract. [64] However, the "[c]ontingency of an obligation does not prevent its being executory under section 365."[65] "Factors relevant in evaluating an LLC operating agreement include whether the operating agreement imposes remote or hypothetical duties, requires ongoing capital contributions, and the level of managerial responsibility imposed on the debtor."[66]

Where the operating agreement, partnership agreement, or other contract is executory and is accepted by the trustee, the trustee must cure any defaults under the executory contract (other than defaults related to an *ipso facto* clause).[67] Upon assumption, the trustee must be prepared to perform future obligations. On the other hand, as set forth in § 365(g), rejection of an executory contract constitutes a breach of such contract or lease.

Is The Operating Agreement or Partnership Agreement an Executory Contract?

Where a contract that becomes property of the estate is not an executory contract, the trustee retains the bankrupt member's or partner's "Owner's Rights and Economic Rights." This is where a divorce from the interests of the other business owners may occur. In most cases, the trustee's goals are short-term—for the benefit of the general unsecured creditors of the bankruptcy estate. The trustee's interests are not necessarily long-term; whereas the interests of the other members or partners in a successful business are usually of a longer term. The trustee may try to use the leverage of the operating agreement or partnership agreement to force a favorable (to the bankruptcy estate) financial settlement from the company or the other owners.

Where the operating agreement, partnership agreement, or other contract is an executory contract, the other members or partners are better protected. To accept the contract, the trustee must be willing to perform all of the executory obligations of the bankrupt debtor. If the trustee rejects the contract, the contract becomes in default and the bankruptcy estate becomes subject to damages and potentially other penalties described in the operating agreement or the partnership agreement that apply on default of an owner.

As discussed below, many cases show that trustees prefer to avoid operating agreements and partnership agreements being categorized as being executory; the remaining business partners would prefer that the agreements be classified as executory.

Personal Services Agreements Cannot Be Assumed.

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[64] *In re* Capital Acquisitions & Management Corp., 341 B.R. 632, 636 (Bankr. N.D. Ill. 2006). Meiburger v. Endeka Enters. LLC (*In re* Tsiaoushis), 383 B.R. 616, 618 (Bankr. E.D. Va. 2007).

[65] Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc. (*In re* Richmond Metal Finishers, Inc.), 756 F.2d 1043, 1046 (4th Cir. 1985).

[66] Warner v. Warner, 480 B.R. 641, 651 (Bankr. N.D. W. Va. 2012) *aff'd sub nom* Sheehan v. Warner, 585 F. App'x 130 (4th Cir. 2014) (holding that "[t]here is a lack of consensus among the courts regarding the executory nature of operating agreements of limited liability companies because there are no *per se* rules regarding the classification of limited liability operating agreements.") (quoting Bensusan v. Prebul (*In re* Prebul), Case No. 09-14010, 2011 Bankr. LEXIS 2795, at *23, 2011 WL 2947045, at *7 (Bankr. E.D. Tenn. July 19, 2011)) (citations omitted) (internal quotation marks omitted)).

[67] 11 U.S.C. § 365(b)(1)(A) (2004).

As discussed above, § 365(e)(1) invalidates provisions that prevent the bankruptcy estate from receiving the benefit of an executory contract. But this provision is not always applicable. Importantly in the case of a bankruptcy filed by a member or partner with Management Rights, § 365(e)(2) provides that § 365(e)(1) does not apply if "applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance or rendering performance to the trustee or to an assignee of such contract . . . "[68]

Where Management Rights are concerned, § 365(c)(1) of the Bankruptcy Code provides that the trustee may not assume or assign an executory contract if:

> (1)(A) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the trustee, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and (B) such party does not consent to such assumption or assignment.

For example, where the bankrupt debtor is a manager or service provider to the limited liability company or partnership pursuant to the operating or partnership agreement and is not permitted to delegate his or her performance, the trustee should not be permitted to assume the managerial role if the other owners object.[69] The contract should be considered to be executory under § 365(e)(2) since there remain unperformed obligations that likely should be considered to be material. The limited liability company or partnership does not have to accept the trustee's performance of those obligations and, therefore, the trustee cannot accept the agreement without the consent of the other members or partners.[70]

Where the trustee does not seek to assume the debtor's role as manager but rather seeks to leave the debtor in that role, as in *Walro v. The Lee Group Holding Company, LLC*,[71] the operating agreement should not (for that reason) be an executory contract. In *Walro*, the bankruptcy court did not perform an analysis whether the operating agreement was an executory contract under § 365, noting that:

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[68] Section 365(e)(2)(A) provides:

> Paragraph (1) of this subsection does not apply to an executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if (A)(i) applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to the trustee or to an assignee of such contract or lease, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties; and (ii) such party does not consent to such assumption or assignment.

[69] Of course, if the terms of the agreement provide that the manager or service provider can delegate performance without breach of the underlying agreements, then the trustee should be able to step into the Management Rights as well.

[70] *See Warner*, 480 B.R. at 650, (the court noted that "[a]n overlap, arguably a conflict, exists between §§ 365 and 541(c)(1). *See In re* Garbinski, 465 B.R. 423, 426 (Bankr. W.D. Pa. 2012) ("Section 365 is thus in apparent conflict, or at least in tension, with 11 U.S.C. sec. 541(c)(1) . . . . "). Section 541(c)(1) voids *ipso facto* provisions while § 365(e)(2) would permit the non-debtor entity to enforce an *ipso facto* clause within the contract."). The court in Warner decided to leave this issue for another day as it had determined that the Operating Agreement in that case was not an executory contract.

[71] 524 B.R. 798, 803-04 (Bankr. S.D. Ind. 2014).

> The Trustee did not seek to step into Debtor's shoes as manager, nor did he ask that the Court compel Debtor to remain as manager. . . . For that reason, the Court need not determine—at least in the context of this proceeding—whether the Code or relevant non-bankruptcy law supports either type of action.[72]

Continuing Duties Are Sufficient to Cause the Operating Agreement to be an Executory Contract.

In *Ebert v. DeVries Family Farm, LLC* (*In re DeVries*),[73] the court reviewed an operating agreement that included three continuing obligations to determine whether they constituted sufficient unperformed obligations to turn the operating agreement into an executory contract:

1. The operating agreement provided that the debtor was obligated to contribute such time to the LLC as necessary for its operations. The court recognized that "whether a debtor is required to participate in any management obligations is a factor that courts consider in determining whether an agreement is an executory contract."[74] However, under the terms of the operating agreement at issue, management was to be solely overseen by the manager who exercised control over 100 percent of the Company and at no point did the Debtor in that case contribute any meaningful amount of time to the Company's business affairs. More importantly, Debtor's failure to participate in management duties did not constitute a "material breach" under the Operating Agreement, did not lead to his dissociation from the Company, nor have any real effect on his membership rights. The court concluded that the debtor's obligation to contribute time to the management of the Company was not an executory obligation.

2. The operating agreement required the members, including the bankrupt debtor, to contribute capital "as may be determined by a majority vote of the Members,"[75] and failure to make the required capital contribution would be cause for termination of membership. The trustee argued that the likelihood of the debtor being required to contribute capital was too remote to be considered an executory obligation. However, the court noted that even though the debtor "has not yet been called on to contribute additional capital to the Company [it] does not relieve Debtor of this obligation."[76] The court went on to note that "given the highly volatile nature of the dairy industry, Debtor's obligation to contribute capital to the Company is neither remote nor hypothetical."[77] Consequently, this obligation to contribute was found to be an executory obligation.

3. The court also found that the obligation set forth in the operating agreement for each member to guarantee loans to the Company if the guarantee was required

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[72] *Id.* at 805.

[73] 2014 WL 4294540 (Bankr. N.D. Tex. Sept. 27, 2014).

[74] *Id.* at *9.

[75] *Id*.

[76] *Id.* at *10.

[77] *Id*.

> by the bank was also an executory obligation and neither remote nor hypothetical.[78] The members had in the past guaranteed such obligations, and the continuing obligation to do so was executory.

The court also discussed the obligations in the cross purchase agreement among the members—an agreement separate from the operating agreement but entered into by the members at the same time.[79] The court found that "it is clear that the parties entered into the Operating Agreement and Cross Purchase Agreement with the intent to create global procedures for the Company" and the two agreements were a "package deal." The court noted that the agreements should therefore be construed as one,[80] and the trustee, by failing to timely assume the Cross Purchase Agreement had therefore also rejected the operating agreement "by operation of law under section 365(d) of the Code."[81]

The *In re DeVries* court then went on to explain what rejection of the executory contracts meant in this context:

By rejecting the Operating Agreement, the Trustee is relieved from performing any future obligations under it,[82] but it has not disappeared. The Operating Agreement still governs the Trustee's rights under it. Therefore, the court must look to the Operating Agreement to determine the effect of its breach.

In this case, the operating agreement said that a member "shall attain the status of a mere assignee if the member breaches the operating agreement" and as a result would no longer be entitled to participate in management (Owner's Rights in this context).[83] The debtor retained the Economic Rights, however.[84]

In another case, Strata Title, LLC filed for bankruptcy protection.[85] Strata was a 45% owner of Santerra Apartments, LLC.[86] Strata's single member, John Lupypciw, is the manager but not a member of Santerra.[87] Santerra's operating agreement required a super-majority (60% vote) by the members to perform certain actions, which the court determined were "not

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[78] *Id.* at *11.

[79] The defendants argued that even if the court found the operating agreement itself not to be an executory contract, the Cross Purchase Agreement and the Operating Agreement should be construed together, and the Trustee's failure to timely assume the Cross Purchase Agreement resulted in a rejection of both the Cross Purchase Agreement and the Operating Agreement. The Cross Purchase Agreement governed, among other things, the transfer of membership units in the event of a member's death or withdrawal, and outlined certain restrictions on alienation of the membership units.

[80] *Citing In re* Mirant Corp., 303 B.R. 319, 322 n.7 (Bankr. N.D. Tex. 2003), *citing with approval* Kopel v. Campanile (*In re* Kopel), 232 B.R. 57, 65 (Bankr. E.D. N.Y. 1999).

[81] *In re DeVries*, 2014 WL 4294540 at ¶ 40.

[82] *Citing* Sunbeam Prods., Inc. v. Chi. Am. Mfg., LLC, 686 F.3d 372, 377 (7th Cir. 2012) (Easterbrook, J.), *cert. denied*, 133 S. Ct. 790 (2012) ("After rejecting a contract, a debtor is not subject to an order of specific performance.") (citing *Bildisco*, 465 U.S. at 531).

[83] *In re DeVries*, 2014 WL 4294540 at ¶ 49.

[84] *Id.* at ¶ 48 n.102.

[85] *In re* Strata Title, LLC, 2013 WL 1773619, *1 (Bankr. D. Ariz. Apr. 25, 2013).

[86] *Id.* at *2 n.11

[87] *Id.* at *1.

remote and are material":

1) Sale of the Property;
2) Refinancing of the Property; and
3) Removal of the manager.[88]

The court found that Santerra (and Mr. Lupypicw) were actively marketing Santerra's property and was facing an upcoming refinancing deadline. The other members of Santerra had made a threat to remove Mr. Lupypciw as manager. Because of the super-majority provisions, the court found that these issues required resolution through the Debtor's active participation and, therefore, the operating agreement in this case was an executory contract. Similarly, in *Milford Power*, the Delaware Chancery Court held that while federal bankruptcy law pre-empted state law, §§ 365(e)(2) and 365(c)(1) created "a strong argument that these sections preclude a Bankruptcy Trustee from assuming at least those aspects of the contract granting the debtor managerial rights even if the Trustee is the debtor in possession."[89] In contrast, however, the Bankruptcy Court in *In re Alameda Investments, LLC*[90] distinguished *In re Strata Title* and stated that the mere fact that members had the right to vote on various matters would not, by itself, make an operating agreement executory.

In *In re Garrison-Ashburn, LC.*[91] the court found that where the bankrupt debtor had no management role or other continuing obligation, the operating agreement was not an executory contract. Nevertheless, the *Garrison-Ashburn* court enforced provisions of the Virginia Limited Liability Company Act which provided a member would be dissociated upon the filing of a bankruptcy petition and retain only Economic Rights as an "assignee." A commentator[92] notes that "Garrison-Ashburn, however, departed from the majority of courts holding that in the case of non-executory agreements, under §541(c)(1), the full bundle of rights associated with an LLC interest (including management rights) would be retained by a debtor after the commencement of a bankruptcy case." This aspect of the decision has been criticized by other courts on the grounds that a statute that relegates a member's interest to those of an assignee is itself "applicable non-bankruptcy law" and an *ipso facto* clause that in effect terminates the debtor's membership interest under § 541(c)(1)(B).[93]

Another case finding that the operating agreement in question was not an executory contract is *In re Ehmann*.[94] There the Bankruptcy Court said:

> While Fiesta undoubtedly owes many obligations to its members pursuant to the Operating Agreement, for the contract to be executory there would also have to be

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88 *Id*. at *2.

89 Milford Power Company, LLC v. PDC Milford Power, LLC, 866 A.2d 738, 752 (Del. Ch. 2004).

90 2013 WL 32116129 (Bankr. C.D. Cal. 2013), *aff'd* 2014 WL 868605 (B.A.P. 9th Cir. 2014).

91 In re Garrison-Ashburn, LC, 253 B.R. 700 (Bankr. E.D. Va. 2000).

92 Lawrence A. Goldman, *The Crossroads of LLCs and Bankruptcy—A Treacherous Intersection* (Bus. Law Section of the Am. Bar Assoc., S. F., Cal.), Apr. 16, 2015.

93 In this regard, *see In re* Kling*er*man, 388 B.R. 677, 679 (Bankr. E.D. N.C. 2008); *In re* La*H*ood, 437 B.R. 330, 336 (Bankr. C.D. Ill. 2010); and *In re* Ellis, 2011 Bankr. LEXIS 4169, *7-8 (Bankr. S.D. Ind. 2011).

94 2005 WL 78921 (Bankr. D. Ariz. Jan. 13, 2005).

> some material obligation owing to the company by the member. Moreover, such member's obligation must be so material that if the member did not perform it, Fiesta would owe no further obligations to that member.[95]

The court went on to discuss its conclusions following "a close reading of the Operating Agreement itself":

> It imposes many obligations on the managers, but as noted above the manager is the Debtor's father, not the Debtor. Article V is entitled "Rights and Obligations of Members," but in fact it identifies only rights and no obligations. . . . In short, the Article of the Operating Agreement that is partially titled "Obligations of Members" reveals that members have no obligations to the Company.[96]

In re Ehmann is, therefore, consistent with other cases where courts have found operating agreements not to be executory contracts where the operating agreement does not require that the bankruptcy debtor perform future services for the limited liability company or partnership entity or perform other material future obligations. In *In re Warner*, the court said:

> In this case, the Operating Agreement reveals that there are no material unperformed and continuing obligations owed by the Debtor: the Debtor is not a manager of McCoy Farm; he has never contributed capital to the LLC; he has no obligation to provide any personal expertise or service to the company; and he may withdraw at any time so long as notice is given.[97]

Where an operating agreement or partnership is not an executory contract, it does not have to be accepted by the trustee. It continues in effect with no change and the trustee steps into the same position as the now-bankrupt debtor occupied. However, by being party to the operating agreement, the trustee only has the same rights and is subject to the same limitations as the debtor originally had, including any limitations on future transferability.

Possible Death-Knell for Pick Your Partner in Bankruptcy?

Unfortunately, however, not all cases are well-argued or well-reasoned or fit within a simple analysis. Judges are generally not business law specialists and do not always give careful analysis to business law principles when deciding cases before them. An example of this is *In re Denman*.[98] In *Denman*, the court also reviewed the operating agreement and determined that an operating agreement was not an executory contract. The court failed to conduct the careful analysis that the *DeVries* court conducted, but rather analyzed the issue as follows:

> The court has extensively reviewed the Operating Agreement of this case and now

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[95] *In re Ehmann*, 319 B.R. at 204.

[96] *Id.*

[97] Sheehan v. Warner (*In re* Warner), 480 B.R. 641, 651 (Bankr. N.D. W. Va. 2012).

[98] *In re* Denman, 513 B.R. 720 (Bankr. W.D. Tenn. 2014). *See* Jay Adkisson, *Denman Creates Confusion for Bankrupt Debtor's Interest in LLC*, FORBES (Dec. 19, 2014), http://onforb.es/1AnT7et.

> finds that it is not an executory contract as contemplated and governed by sec. 365 of the Bankruptcy Code. As the title of the Operating Agreement indicates, this agreement is meant to operate Opus, a separate legal entity from its members. The Operating Agreement establishes rights and duties attached to the Membership Interests. The members were required to make an "Initial Contribution" under Section 6.1 of the Operating Agreement to capitalize Opus. No other material member obligations appear to exist under this Operating Agreement.[99]

Had the court stopped its discussion here, the issue would have been clear – no continuing material obligations in the operating agreement means that the operating agreement would not be treated as an executory contract under 11 U.S.C. § 365. Unfortunately, the court went on to confuse the issue significantly, stating:

> The Operating Agreement here is a Tennessee LLC operating agreement subject to the Tennessee LLC Act. The Operating Agreement is a legal instrument that defines the membership interests and rights that each member holds in Opus. These membership interests are personal property of the individual members analogous to shares of corporate securities. Mr. Denman's Membership Interest became property of the sec. 541(a) estate upon the filing of his Chapter 13 petition. 11 U.S.C. sec. 541(a). In conclusion, the LLC operating agreement here is not an executory contract and is more appropriately classified as a business formation and governance instrument; therefore, the Opus Operating Agreement here is not an executory contract under sec. 365, however, Mr. Denman's Membership Interest is sec. 541 property of the estate.[100]

Few experienced business lawyers would consider LLC membership interests to be "analogous to corporate securities." First of all, the term "securities" is an extremely broad term that invokes consideration of federal and state securities laws as well as, perhaps, article 8 of the Uniform Commercial Code. Even if read to mean "shares of corporate stock," there are significant differences between corporate stock and interests in limited liability companies and partnerships, and the separation between Economic Rights, Owner's Rights, and Management Rights is only one of those differences.

Perhaps the more surprising (and inaccurate) statement is the court's effort to distinguish "a business formation and governance instrument" from the entire world of contracts. If not a contract, what can it be?

Professor Carter Bishop has expressed the fear that *Denman*, if followed in the future, would mean that a bankruptcy trustee could obtain all of a debtor's LLC interest and deal with it notwithstanding any contractual restrictions.[101] The authors believe that *Denman* should be considered an outlier and, at worst, limited to an interpretation of the Tennessee LLC Act

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[99] *Id.* at 726.

[100] *Id.* (The court also said that "in essence, the LLC obligations are unilateral obligations to the LLC and not bilateral obligations among members." (*Id.* at 724)).

[101] Email from Professor Carter G. Bishop, Professor of Law, (Suffolk University, to lnet-llc@yahoogroups.com (Nov. 21, 2014, 07:03 MDT) (on file with author).

which is significantly different than other state LLC Acts.

- Unlike many LLC Acts, the Tennessee LLC Act does not contain a provision stating that "it is the intent of this article to give the maximum effect to the principle of freedom of contract and to the enforceability of operating agreements."[102]

- The Tennessee LLC Act defines "LLC Documents" as either, or both, the LLC's articles and, "*if the LLC has an operating agreement*, whether written or oral, its operating agreement."[103]

- Unlike other LLC Acts, the Tennessee LLC Act contemplates that all provisions that would normally be included in an operating agreement may be set forth in the LLC's articles.[104] Although this would be possible under other LLC Acts, it is not customary practice.[105]

- The Tennessee LLC Act also contains a very corporate-like provision relating to the classification of interests, providing, inter alia, that "the LLC documents may denominate membership interests or financial rights as units, shares, percentages, participations, distribution interests, ownership or economic interests, with or without voting rights, and with or without fixed or variable rights to participate in distributions, assets and properties, allocations of profits and losses and fixed or variable obligations to the LLC or any combination thereof."[106]

The court in *Denman* showed its lack of understanding of LLCs in general and of Tennessee LLCs in particular. The court discussed single-member LLCs even though the LLC at issue in Denman was not a single-member LLC. The court noted that Tennessee law provides that a new members are deemed to have agreed to the operating agreement[107] and stated:

> This makes sense if the LLC operating agreement is considered a governance instrument merely defining the membership interests. However, under contract law, parties cannot be deemed to be parties to a contract without their consent. Similarly, parties to contracts must mutually assent to amendments to existing contracts; whereas, LLC agreements may be amended without all members approving. TENN. CODE ANN. §48-206-102(b). Such LLC provisions undermine the privity of contract and demonstrate that LLC operating agreements are unique instruments apart from

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[102] *E.g.*, COLO. REV. STAT. § 7-80-108(4) (2004) (LLCs); *see also* DEL. Code Ann., tit. 6, § 15-103(d) (2009) (partnership agreements) and § 18-1101(b) (2013) (LLCs). The authors submit that there is no authority or policy reason that such a statutory statement should be applicable to establish that an LLC is essentially a creature of contract.

[103] TENN. CODE ANN. § 48-249-102(16) (2014) (emphasis added).

[104] *Id*. at § 48-249-202(b)(1).

[105] *See, e.g.*, COLO. REV. STAT. § 7-80-204(1)(f) (2004); *see generally*, Herrick K. Lidstone, Jr. and Allen Sparkman, LIMITED LIABILITY COMPANIES AND PARTNERSHIPS IN COLORADO § 3.1.6 (CLE in Colorado, Inc. 2015).

[106] TENN. CODE ANN. § 48-249-303(a) (2014).

[107] *Id*. at §48-206-102(a).

executory contracts.

The court ignored the fact that members must agree to become members and that agreement constitutes their assent to the operating agreement and to its amendment provisions. The court also failed to note that Tennessee law provides that members of an LLC may enter into an operating agreement not just "to regulate the affairs of the LLC and the conduct of its business" but also "to govern relations between or among the members."[108] Something that governs relations between or among the members sounds like a contract.

Despite the *Denman* court's apparent misunderstanding of LLCs, the court raises what may be a more important issue. Discussing both the Countryman and Sixth Circuit definitions of executory contracts,[109] the court noted that a member's breach of an operating agreement did not excuse performance by the other members or the by LLC—meaning that the other members of the LLC have to perform for the benefit of the LLC (and the bankrupt member's estate) notwithstanding the estate's default under the terms of the operating agreement. This was clearly a bankruptcy favorable, owner-entity unfavorable opinion which hopefully will have limited future effect. However, *Denman*, as well as *In re Ehmann*,[110] appear to be consistent with the view expressed by the United States Supreme Court that the legislative history of Section 365(a) indicates that Congress intended that an executory contract be defined as a contract "on which performance is due to some extent on both sides."[111] To the extent that the view expressed in *Denman* and *In re Ehmann* is widely adopted in the future, the "pick your partner" likely becomes meaningless in the bankruptcy context.

Arguments exist to counter the *Denman* and *In re Ehmann* view. Some courts have held that "even though there may be material obligations outstanding on the part of only one of the parties to the contract, a contract may nevertheless be deemed executory under the functional approach if its assumption or rejection will ultimately benefit the estate and its creditors."[112] Assume the following situation:

> Closely Held LLC, a Texas limited liability company, is managed by Bob Debtor, who is one of four equal members of Closely Held LLC. Because he is a member, Bob Debtor receives no compensation from Closely Held LLC for serving as its manager.
>
> Bob Debtor has also licensed certain intellectual property to Closely Held LLC. Under the license agreement, Closely Held LLC pays royalties to Bob Debtor. Bob Debtor's only ongoing obligations under the license agreement are to license any future developments that Bob Debtor may develop in the intellectual property and to cooperate with Closely Held LLC in any action to defend the rights of Closely Held LLC in the intellectual property. Bob Debtor has no obligation to work on future

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108 *Id*. at § 48-249-203(a).

109 *See* Countryman, *supra*, note 57; Founier & Schanne, *supra* note 58 and accompanying text.

110 *See supra*, note 62 and accompanying text.

111 *See supra*, note 55 and accompanying text.

112 *In re* Cardinal Industries, Inc., 146 B.R. 720, 729 (Bankr. S.D. Ohio 1992); *accord*, *In re* Arrow, Inc., 60 B.R. 117, 122 (Bankr. S.D. Fla. 1986).

developments of the intellectual property.

Bob Debtor files for bankruptcy because of debts incurred in an unrelated business.

At least under the functional approach, Bob Debtor's position as manager of Closely Held LLC should be considered an executory contract. If so, Closely Held LLC should not be required to accept further service from Bob Debtor as manager pursuant to Section 365(e)(2) of the Bankruptcy Code unless the trustee assumes the operating agreement as an executory contract. If the trustee assumes the executory contract, Bob Debtor can continue to provide services to the LLC since the restrictions of § 365(c)(1) and § 365(e)(1) would not be applicable.[113] If the contract is determined not to be executory, Bob Debtor can continue to provide services as manager without question. On the other hand, the license would not appear to be an executory contract unless the facts demonstrate that the likelihood of valuable future developments to the intellectual property is such that Bob Debtor's knowledge is vital to those possible developments. In that case, Closely Held LLC should be able to prevent assignment of Bob Debtor's rights under the license.[114]

Note that if neither Bob Debtor's position as manager nor the license agreement is considered an executory contract, Closely Held LLC would be forced to accept an individual as manager who at best will be distracted by his bankruptcy and could lose the benefit of possible future developments in the intellectual property that Bob Debtor might achieve. This would be untenable from a policy standpoint.[115]

CONCLUSION

When attorneys make appropriate arguments and courts carefully consider the law, elements of "pick your partner" should survive even through a bankruptcy of a member or partner. While it is true that Economic Rights and Owner's Rights will become included in the bankruptcy estate under § 541(a), where the operating agreement or partnership agreement is an executory contract the trustee may be required to make a decision whether to accept (and

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[113] Where Bob Debtor was the manager before the bankruptcy and following the filing of the petition, Closely Held LLC will be accepting services only from him. In §§ 365(c)(1) and (e)(1), the Bankruptcy Code prohibits persons other than the person already performing the services (that is an assignee) from acquiring the Management Rights without the other parties' consent.

[114] Intellectual property rights are subject to the following rules:

An exclusive copyright license provides the licensee with a property right that is freely transferrable. A non-exclusive copyright license cannot, as a matter of law, be assigned without the owner's consent. *In re* Sunterra Corp., 361 F. 3rd 257, 260 (4th Cir. 2004); *In re* Golden Brooks Fam. Ent., Inc.,. 269 B.R. 300, 309 (Bankr. D. Del. 2001).

Both exclusive and non-exclusive patent licenses are personal and non-delelegable. *In re* Catapult Ent., Inc. 165 F. 3d 747 (9th Cir. 1999); *In re* Aerobox Structures, LLC, 373 B.R. 135, 141 (Bankr. D. N.M. 2007).

Trademark licenses are not assignable absent a clause expressly authorizing assignment. *In re* XMH Corp., 647 F.3d 690 (7th Cir. 2001).

For a collection of cases on the executory contract status of intellectual property and technology licenses, *see* Michelle Morgan Harner, Carl E. Black, & Eric R. Goodman, *Debtors Beware: The Expanding Universe of Non-Assumable/Non-Assignable Contracts in Bankruptcy*, 13 Am. Bankr. Inst. L. Rev. 187, 192 n.24 (2005).

[115] *See In re* First Protection, Inc., 440 B.R. 821 (B.A.P. 9th Cir. 2010) (The purpose of Section 365(c)(1) is "to protect non-debtor third parties whose rights may be prejudiced by having a contract performed by an entity other than the one with which they originally contracted.").

therefore perform future obligations) or reject (and therefore be in default under the contract).

When a member or partner files a petition in bankruptcy, relationships and goals change. The trustee's obligation is to act for the benefit of unsecured creditors of the bankruptcy estate in general – and whether to keep the business operating is a subset of the much larger goal. Where the bankrupt member or partner has a controlling vote, that vote will likely go to the trustee who may use the vote to replace a manager or to dissolve the entity. In that case, the trustee will likely argue to prevent the operating agreement or partnership agreement from being treated as an executory contract – the trustee would prefer simply to step into the bankrupt member's or partner's Economic Rights and Owner's Rights with no action to accept or reject an agreement being required.

Unfortunately, the courts are not always clear in their determination as to what constitutes an executory contract or the legal elements considered in determining whether an agreement is in fact an executory contract. A commentator[116] has summarized this well when he stated "the state of the law concerning the enforceability of [*ipso facto*] clauses, or provisions of State limited liability company acts purporting to cause a change of the nature of an interest in a limited liability company upon the holder's bankruptcy, continues to evolve and can best be described as murky." The same can be said about bankruptcy court interpretation of most aspects of the relationship between the bankrupt member or partner and the entity (LLC or partnership). The commentator went on to summarize "the current state of the law" as follows:

1. A debtor will retain economic rights in an LLC regardless of language in an LLC agreement or a statutory default rule that purports to cause a termination or automatic transfer of such rights upon the filing of a bankruptcy case.

2. A debtor's retention of non-economic rights attendant to an LLC interest (i.e., continued participation in management, right to vote, right to financial information) will depend on whether the LLC agreement at issue is executory. If the agreement is not executory, the trustee should retain such rights. If the contract is assumed, whether the trustee has the right to assign the contract may depend on restrictive provisions of the contract unrelated to the event of the debtor's bankruptcy.

3. If the LLC agreement is executory, whether a trustee or an assignee of a debtor or bankruptcy trustee, retains non-economic rights will depend on the particular facts and circumstances at issue and whether the court applies a hypothetical or actual test of assignability. In particular, the language of the LLC statute or agreement, or the terms of other applicable non bankruptcy law will have to be analyzed to determine whether the assignment of certain contract rights is forbidden. Finally, if assignability is forbidden, upholding an *ipso facto* clause may depend on whether the identity of a party is material to the contract.

There are many factors that are involved in the determination whether contracts such as operating agreements and partnership agreements are executory, the damages when executory

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[116] Lawrence A. Goldman, *The Crossroads of LLCs and Bankruptcy—A Treacherous Intersection*, (Bus. Law Section of the Am. Bar Assoc., S. F., Cal.), Apr. 16, 2015.

contracts are rejected, and the respective rights of the parties to the contract following acceptance or rejection; as a result, each case requires a fact-intensive inquiry that must address the particular circumstances of the issues being presented and the agreement under consideration.

The courts have told us (and will likely continue to tell us) what the battleground issues are and it will be up to the litigators presenting the cases to the courts to make their arguments. The authors hope that the litigators' arguments will be made with the assistance of attorneys who understand limited liability company and partnership law.

2015 TEXAS LEGISLATIVE UPDATE ON ENTITY LAW

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I. INTRODUCTION AND BACKGROUND

This article summarizes several pieces of legislation passed by the Texas Legislature in its 2015 Regular Session that amend primarily the Texas Business Organizations Code (the "*Code*").[2]

Senate Bill No. 859 (*S.B. 859*) was authored by Senator Kevin Eltife, sponsored by Representative Rene Oliveira, and became effective on September 1, 2015, with portions becoming effective on January 1, 2016. S.B. 859 makes several technical and substantive amendments to the Code relating to partnerships and limited liability companies.

Senate Bill No. 860 (*S.B. 860*) was authored by Senator Kevin Eltife, sponsored by Representative Rene Oliveira, and became effective on September 1, 2015. S.B. 860 makes several technical and substantive amendments to the Code relating to corporations and fundamental business transactions.

Senate Bill No. 1077 (*S.B. 1077*) was authored by Senator Kevin Eltife, sponsored by Representatives Rene Oliveira and Tan Parker, and became effective immediately upon signature by Governor Greg Abbott on May 23, 2015. S.B. 1077 makes a clarifying amendment to the defined term "person" in Chapter 1 of the Texas Business & Commerce Code (the *TBCC*).

House Bill No. 2891 (*H.B. 2891*) was authored by Representatives John Otto, Andrew Murr, and Chris Fallon, sponsored by Senators Charles Perry and Konni Burton, and becomes effective on January 1, 2016. H.B. 2891 makes substantive amendments to the Code and the Texas Tax Code to make professional associations and limited partnerships subject to annual public information report filing requirements.

Senate Bill 1313 (*S.B. 1313*) was authored by Senators Kirk Watson and Royce West, sponsored by Representative Jason Villalba, and became effective immediately upon signature by the Governor on June 19, 2015. S.B. 1313 amends the Code to require a notarized written consent by any person or entity that is consenting to the use by another entity of a similar name.

As background information, the Code was originally adopted by the 2003 Texas Legislature.[3] The Code codified the provisions of prior law found in the Texas Business Corporation Act (*TBCA*), Texas Non-Profit Corporation Act (*TNPCA*), Texas Miscellaneous Corporation Laws Act (*TMCLA*), Texas Limited Liability Company Act (*TLLCA*), Texas Revised Limited Partnership Act (*TRLPA*), Texas Real Estate Investment Trust Act (*TREITA*), Texas Uniform Unincorporated Nonprofit Associations Act (*TUUNAA)*, Texas Professional Corporation Act (*TPCA*), Texas Professional Associations Act (*TPAA*), the Texas Revised Partnership Act (*TRPA*), the Cooperative Associations Act (*CAA*), and other existing provisions of Texas statutes governing domestic entities.[4]

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[2] TEX. BUS. ORGS. CODE ANN. (Vernon Supp. 2008).

[3] Acts 2003, 78th Leg., ch. 182 (H.B. 1156), effective January 1, 2006.

[4] The Code was a joint project of the Business Law Section of the State Bar of Texas and the Office of the

The effective date of the Code was January 1, 2006, and the Code applied to domestic (Texas) entities formed after that date. The Code generally did not apply prior to January 1, 2010 to a domestic entity that existed on or before January 1, 2006, unless the entity expressly elected to adopt the Code as its governing statute. On January 1, 2010, the Code began to apply to all domestic entities that existed on or before January 1, 2006.[5]

Unless otherwise indicated, all references to a "Chapter," "Section" or "Subsection" are to a Chapter, Section or Subsection of the Code.

II. FUNDAMENTAL BUSINESS TRANSACTIONS

S.B. 860 amended various provisions of Chapter 10 of the Code relating to fundamental business transactions, which include mergers, conversions or interest exchanges. Most of the changes are based on provisions contained in the Model Business Corporation Act (*MBCA*) or the Delaware General Corporation Law (*DGCL*).

Owner Liability. The first set of amendments are based on the MBCA and clarify that an owner or a member of a domestic entity cannot become subject to owner liability as a result of a merger, conversion, or interest exchange transaction without the consent of that owner or member. The provisions introduce a new definition of "owner liability" in Section 1.002 of the Code.[6] The new defined term refers to personal liability only for liabilities or other obligations that are imposed on a person (a) by statute solely by reason of the person's status as an owner or member or (b) by a governing document of an organization under a provision of the Code or the law of the organization's jurisdiction of formation that authorizes the governing document to make one or more specified owners or members liable in their capacity as such for all or specified liabilities or other obligations of the organization. It does not include liabilities or other obligations that an owner or member may incur or assume by contract or agreement, such as a guaranty of an organization's obligations, other than an agreement contained within a governing document of the organization. The definition is based on Section 1.40(15C) of the MBCA.

With the new defined term, amendments are made to the corresponding provisions governing mergers, conversions, and interest exchanges in Chapter 10.[7] These amendments specify that the consent of an owner or a member to becoming personally liable as a result of a merger, interest exchange, or conversion is required as a condition to the plan of merger, plan of exchange or plan of conversion only if that personal liability is "owner liability." These provisions are based on sections 11.04(i) and 9.52(7) of the MBCA. These amendments are

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Texas Secretary of State. The Texas Legislative Council also assisted in the editing and drafting of the Code. The 2005 Texas Legislature passed House Bill 1156 containing numerous technical amendments to the Code. The 2007 Texas Legislature passed House Bill 1737 containing numerous technical amendments and several substantive amendments to the Code. The 2009 Texas Legislature passed Senate Bill 1442 containing numerous technical and substantive amendments to the Code. The 2011 Texas Legislature passed Senate Bill 748 containing numerous technical and substantive amendments to the Code. The 2013 Texas Legislature passed Senate Bill 847 containing several technical and substantive amendments to the Code and Senate Bill 849 authorizing for-profit corporations to specify one or more "social purposes" in their certificates of formation.

[5] *See* TEX. BUS. ORGS. CODE ANN §§402.001–.005.

[6] S.B. 860 § 1 (adding TEX. BUS. ORGS. CODE ANN. § 1.002(63-a)).

[7] *Id.* §§ 5, 9, 11 (amending TEX. BUS. ORGS. CODE ANN. §§ 10.001(e), 10.051(f), 10.101(f)).

clarifications of Texas law because the provisions in effect before the amendments, which required consent to becoming "personally liable" (based on a previous version of the MBCA), have been understood by practitioners to refer only to personal liabilities imposed on owners or members directly or indirectly pursuant to statute or the governing documents.

Use of Formula. Various provisions of Chapter 10 were revised to clarify that a formula can be used to determine the manner and basis of converting or exchanging ownership or membership interests (a) in a plan of merger, (b) in a plan of exchange, or (c) in a plan of conversion.[8] These changes are intended to correspond in concept to recent changes made to the DGCL merger and conversion provisions. These changes are clarifications of Texas law because the use of a formula has been considered implicitly authorized by the existing provisions of the Code. S.B. 860 also makes a parallel amendment to clarify that the board of directors of a for-profit corporation can specify that a formula be used to determine the amount of consideration to be received for the issuance of shares in the corporation.[9] This change is based on a recent change in the DGCL and is intended to confirm what is implicit in existing Texas law.[10]

Interests Can Remain Outstanding. Several provisions of Chapter 10 were also revised to clarify that the ownership or membership interests of an organization that is a party to the merger can remain outstanding rather than being converted or exchanged as part of the merger if the organization survives the merger.[11] Again, these changes are based on language in the DGCL and confirm what has been understood to be existing Texas law and practice in this area.

Plans Not Required to be Signed. Several extraneous references to "signed" with respect to a plan of merger, plan of exchange, or plan of conversion have been removed. While a plan of merger, exchange, or conversion must be in written form, it does not need to be separately signed, but only needs to be adopted or approved in conformance with the requirements of the Code.[12]

Plans can be Dependent on Outside Facts. S.B. 860 clarifies that any of the terms of a plan of merger, plan of exchange, or plan of conversion may be made dependent on facts ascertainable outside of the plan if the plan clearly and expressly states the manner in which those facts will operate on the terms of such transaction.[13] The term "facts" includes the occurrence of any event, including the determination or action by any person.[14] As an example, a merger can be conditioned on the occurrence of certain events, such as a necessary regulatory approval. The added provisions are based primarily on language in the DGCL[15] and are considered clarifying, and not substantive, changes to prior Texas law.

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[8] *Id.* §§ 6, 10, 12 (amending TEX. BUS. ORGS. CODE ANN. §§ 10.002(a)(5), 10.052(a)(5) ,10.103(a)(5)).

[9] *Id.* § 24 (adding TEX. BUS. ORGS. CODE ANN. § 21.160(d)).

[10] *See* DEL. CODE ANN. tit. 8, § 152 (2015).

[11] S.B. 860 §§ 6, 8 (amending TEX. BUS. ORGS. CODE ANN. §§ 10.002(a)(6) and 10.008(a)(8)).

[12] *Id.* §§ 13, 14 (amending TEX. BUS. ORGS. CODE ANN. §§ 10.151(b)(1)(G), 10.154(b)(1)(C)–(D)).

[13] *Id.* §§ 6, 10, 12 (adding TEX. BUS. ORGS. CODE ANN. §§ 10.002(d), 10.052(c), 10.103(c)).

[14] *Id.*

[15] *See, e.g.*, DEL. CODE ANN. tit. 8, § 251(b).

Attachment of Amended and Restated Certificate of Formation to Plan of Merger. The Texas Secretary of State has interpreted the provisions of the Code prior to S.B. 860 as prohibiting the attachment of an amended and restated certificate of formation to a certificate of merger to reflect any amendments that were adopted as part of the plan of merger. Such procedure is allowed in various other states, including in Delaware.[16] In Texas, prior practice has been to include any amendments specifically as part of the certificate of merger, but not to amend and restate the certificate of formation of a surviving filing entity. Substantive amendments have been made by S.B. 860 to authorize a plan of merger to include restatements or amendments and restatements of governing documents, including a certificate of amendment, a restated certificate for formation without amendment, or a restated certificate of formation containing amendments.[17] As a result of other changes made by S.B. 860, amendments to the certificate of formation of a surviving domestic filing entity are authorized to be set forth in a restated certificate of formation containing amendments or a certificate of amendment attached to the certificate of merger so long as the certificate of merger includes a statement that the amendments are being made as set forth in such attachments. In addition, a restated certificate of formation containing no amendments may be attached to the certificate of merger.[18] The Code was also amended to make clear that a certificate of amendment, a restated certificate of formation without amendment, or a restated certificate of formation containing amendments of a surviving filing entity will have the effect stated in Code section 3.063 (which makes the restated certificate of formation the superseding and effective certificate of formation).[19]

III. CERTIFICATED AND UNCERTIFICATED OWNERSHIP INTERESTS

S.B. 860 clarifies that a for-profit corporation, real estate investment trust, or professional corporation may issue and have outstanding both certificated and uncertificated ownership interests of the same class or series at the same time, as provided by the entity's governing documents or a resolution adopted by its governing authority.[20] The amendment conforms certain of the language more closely to former Article 2.19.A of the TBCA and to current section 158 of the DGCL.

IV. RATIFICATION OF VOID OR VOIDABLE CORPORATE ACTS OR SHARE ISSUANCES

S.B. 860 adds new Subchapter R to Chapter 21, containing provisions that specify procedures for ratification of void or voidable corporate acts or share issuances by for-profit corporations. These provisions are modeled on relatively new provisions added to the DGCL.[21]

Definitions. New definitions of "corporate statute," "defective corporate act," "district court," "failure of authorization," "overissue," "putative shares," "time of the defective

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16 *See, e.g.*, *id.* § 251(c).

17 S.B. 860 § 7 (amending TEX. BUS. ORGS. CODE ANN. § 10.004(1)).

18 *Id.* § 13 (amending TEX. BUS. ORGS. CODE ANN. § 10.151(b)(1) and adding § 10.151(d)).

19 *Id.* § 8 (amending TEX. BUS. ORGS. CODE ANN. § 10.008(a)(6)).

20 *Id.* § 4 (amending TEX. BUS. ORGS. CODE ANN. § 3.201(b)).

21 *See* DEL. CODE ANN. tit. 8, §§ 204–05.

corporate act," "validation effective time," and "valid shares" have been added that apply to Subchapter R.[22]

1. "district court" is defined to mean a district court in the county where the corporation's principal office in Texas is located or a county in which the corporation's registered office in Texas is located if the corporation does not have a principal office in Texas.[23]

2. "defective corporate act" means an overissue; an election or appointment of directors that is void or voidable due to a failure of authorization; or any act or transaction purportedly taken by the corporation that is, and at the time the act or transaction was purportedly taken would have been, within the power of the corporation to take under the corporate statute, but is void or voidable due to a failure of authorization.[24]

3. "failure of authorization" means the failure to authorize or effect an act or transaction in compliance with the provisions of the corporate statute, the corporation's governing documents, or any plan or agreement to which the corporation is a party, to the extent the failure would render the act or transaction void or voidable.[25]

4. "overissue" means the purported issuance of shares in excess of the number of shares that the corporation has the power to issue at the time of issuance of shares that are not at the time authorized for issuance by the governing documents of the corporation.[26]

5. "corporate statute" means the Code, the TBCA, or any predecessor Texas statute that governs the action or the filing.[27]

6. "putative shares" means the shares of the corporation that were created or issued pursuant to a defective corporate act that would constitute valid shares, if not for a failure of authorization, or cannot be determined by the board of directors to be valid shares.[28]

7. "valid shares" means the shares of any class or series of the corporation that have been authorized and validly issued in accordance with the corporate statute.[29]

8. "time of the defective corporate act" means the date and time the defective

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[22] S.B. 860 § 30 (adding TEX. BUS. ORGS. CODE ANN. § 21.901).

[23] *Id*. (adding TEX. BUS. ORGS. CODE ANN. § 21.901(c)).

[24] *Id*. (adding TEX. BUS. ORGS. CODE ANN. § 21.901(2)).

[25] *Id*. (adding TEX. BUS. ORGS. CODE ANN. § 21.901(4)).

[26] *Id*. (adding TEX. BUS. ORGS. CODE ANN. § 21.901(5)).

[27] *Id*. (adding TEX. BUS. ORGS. CODE ANN. § 21.901(1)).

[28] *Id*. (adding TEX. BUS. ORGS. CODE ANN. § 21.901(6)).

[29] *Id*. (adding TEX. BUS. ORGS. CODE ANN. § 21.901(9)).

corporate act was purported to have been taken.[30]

9. "validation effective time" or "effective time of the validation" means the later of (a) the time at which the resolution submitted to the shareholders for adoption under Subchapter R is adopted by the shareholders or, if no shareholder approval is required, the time at which the notice required by Subchapter R is given, or (b) the time at which any certificate of validation filed under Subchapter R takes effect.[31]

General Effect of Ratification or Court Validation. Defective corporate acts or putative shares are not void or voidable solely as a result of a failure of authorization if the act or shares are ratified in accordance with Subchapter R or validated by the district court in a proceeding brought under Section 21.914 of Subchapter R.[32] The board and shareholder ratification procedures and the court validation procedure under Subchapter R are not the exclusive means of ratifying or validating any defective corporate act or defective issuance of shares.[33] The absence or failure of the ratification of an act or transaction in accordance with Subchapter R or a validation of an act or transaction by a district court under Subchapter R does not, of itself, affect the validity or effectiveness of any act or transaction or the issuance of any shares properly ratified under common law or otherwise. Nor does this absence or failure create a presumption that any such act or transaction is or was a defective corporate act or that those shares are void or voidable.[34]

Ratification by Board. Ratification of the defective corporate act or putative shares requires that the board of directors first adopt a resolution stating (a) the defective corporate act to be ratified, (b) the time of the defective corporate act, (c) if the defective corporate act involved the issuance of putative shares, the number and type of putative shares issued, and the date or dates on which the putative shares were purportedly issued, (d) the nature of the failure of authorization with respect to the defective corporate act to be ratified, and (e) that the board of directors approves the ratification of the defective corporate act.[35] The resolution may also state that, notwithstanding adoption of the resolution by the shareholders, the board may decide, at any time before the validation effective time, to abandon the resolution without further shareholder action.[36] In the absence of actual fraud in the transaction, the judgment of the board of directors that shares of the corporation are valid shares or putative shares is conclusive, unless otherwise determined by the district court in a proceeding brought under Subchapter R.[37]

Shareholder Approval. The board's resolution must be submitted to shareholders for adoption unless no provision of the corporate statute and no provision of the governing documents of the corporation or any plan or agreement to which the corporation is a party

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[30] *Id*. (adding TEX. BUS. ORGS. CODE ANN. § 21.901(7)).

[31] *Id*. (adding TEX. BUS. ORGS. CODE ANN. § 21.901(8)).

[32] *Id*. (adding TEX. BUS. ORGS. CODE ANN. § 21.902).

[33] *Id*. (adding TEX. BUS. ORGS. CODE ANN. § 21.913(a)).

[34] *Id*. (adding TEX. BUS. ORGS. CODE ANN. § 21.913(b)).

[35] *Id*. (adding TEX. BUS. ORGS. CODE ANN. § 21.903(a)).

[36] *Id*. (adding TEX. BUS. ORGS. CODE ANN. § 21.903(b)).

[37] *Id*. (adding TEX. BUS. ORGS. CODE ANN. § 21.912).

would have required shareholder approval of the defective corporate act to be ratified either at the time of the defective corporate act or at the time when the board adopts the required resolution.[38] In addition, shareholder approval will always be required if the defective corporate act results from a failure to comply with Subchapter M of Chapter 21 relating to business combination transactions with affiliated shareholders.[39]

The procedures for submission of the resolution to shareholders and the voting requirements are specified in detail. Notice of the time, place (if any) and purpose of the meeting must be given at least 20 days before the date of the meeting to each holder of valid shares and putative shares, whether voting or nonvoting.[40] In addition, notice must be given to each holder of record of valid shares and putative shares, regardless of whether the shares are voting or nonvoting, as of the time of the defective corporate act, except that notice is not required to be given to a holder whose identity or address cannot be ascertained from the corporation's records.[41] The notice must contain a copy of the board resolution[42] and a statement of the 120-day deadline after the validation effective time for any claim that the defective corporate act or putative shares ratified under Subchapter R are void or voidable due to the identified failure of authorization or any claim that the district court, in its discretion, should declare that a ratification made in accordance with Subchapter R not take effect or that it take effect only on certain conditions.[43] The quorum and voting requirements for shareholders at the meeting are the same as those applicable at the time of such adoption by the shareholders for the type of defective corporate act to be ratified.[44] If a larger number or portion of shares of any class or series of shares or of specified shareholders would have been required under the corporation's governing documents, any plan or agreement to which the corporation was a party or any provision of the corporate statute as in effect at the time of the defective corporate act, then such larger number or portion of shares or of any class or series of shares or specified shareholders is required for a quorum to be present and to adopt the resolution.[45] The adoption of a resolution to ratify the election of a director requires the affirmative vote of a majority of shares present at the meeting and entitled to vote on the election of the director unless the governing documents of the corporation then in effect or in effect at the time of the defective election require or required a larger number or portion of shares to elect the director, in which case the affirmative vote of such larger number or portion of shares is required.[46]

Certificate of Validation. The filing of a certificate of validation with the filing officer is required if the defective corporate act being ratified would have required the filing of a filing instrument or document with the filing officer.[47] The certificate of validation must include the following: (a) a copy and "the date of adoption of the resolution by the board of directors and,

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[38] *Id*. (adding TEX. BUS. ORGS. CODE ANN. § 21.905).

[39] *Id*. (adding TEX. BUS. ORGS. CODE ANN. § 21.905(2)).

[40] *Id*. (adding TEX. BUS. ORGS. CODE ANN. § 21.906(a)).

[41] *Id*. (adding TEX. BUS. ORGS. CODE ANN. § 21.906(a) and (b)).

[42] *Id*. (adding TEX. BUS. ORGS. CODE ANN. §21.906(c)(1)).

[43] *Id*. (adding TEX. BUS. ORGS. CODE ANN. § 21.906(c)).

[44] *Id*. (adding TEX. BUS. ORGS. CODE ANN. § 21.907(a)).

[45] *Id*. (adding TEX. BUS. ORGS. CODE ANN. § 21.907(a) and (b)).

[46] *Id*. (adding TEX. BUS. ORGS. CODE ANN. § 21.907(c)).

[47] *Id*. (adding TEX. BUS. ORGS. CODE ANN. § 21.908(a)).

if applicable, the date of adoption by the shareholders and a statement that the resolution was adopted in accordance with [Subchapter R]"; (b) "the title and date of filing of [any previously filed] filing instrument or document" related to the defective corporate act and any "certificate of correction to the filing instrument"; and (c) "the provisions that would be required under [the Code] to be included in the filing instrument that otherwise would have been required to be filed with respect to the defective corporate act."[48]

Effect of Ratification. On and after the validation effective time, the defective corporate act is no longer deemed void or voidable retroactive to the time of the defective corporate act.[49] In addition, on or after the validation effective time, any putative share purportedly issued pursuant to such defective corporate act will no longer be deemed void or voidable as a result of a failure of authorization identified in the curative resolution but will be deemed to be an identical share outstanding as of the time it was purportedly issued.[50]

Notice of Ratification to Shareholders. A notice must be given to all holders of valid shares and putative shares, whether voting or nonvoting, of the adoption of the ratifying resolution by the board of directors.[51] The "notice [. . . must] also be given to each holder of record of valid shares and putative shares, . . . whether . . . voting or nonvoting, as of the time of the defective corporate act, except that notice is not required to be given to a holder whose identity or address cannot be ascertained from the corporation's records."[52] The foregoing notice is not required if notice of the resolution is given in accordance with procedures for shareholder approval of the resolution as described above.[53] The notice must contain a copy of the resolution and a statement that the following must be brought not later than 120 days after the validation effective time: (a) any claim that the defective corporate act or putative shares ratified under Subchapter R are void or voidable due to the identified failure of authorization or (b) any claim that the district court, in its discretion, should declare that a ratification made in accordance with Subchapter R not take effect or that it take effect only on certain conditions.[54]

Validation Procedures for a District Court. A corporation, any successor entity to the corporation, any member of the board of directors, any record or beneficial holder of valid shares or putative shares currently or as of the time of the defective corporate act that was ratified pursuant to Subchapter R, or any other person claiming to be substantially and adversely affected by a ratification under Subchapter R may apply to a district court, pursuant to new Section 21.914, to determine the validity and effectiveness of various matters relating to any defective corporate act or transaction or to modify or waive any of the procedures set forth in Subchapter R to ratify a defective corporate act.[55] Actions that the district court may take as a result of the application include declaring that putative shares are valid shares, ordering the filing officer to accept an instrument for filing with a prior effective date and time,

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[48] *Id*. (adding TEX. BUS. ORGS. CODE ANN. § 21.908(b)).

[49] *Id*. (adding TEX. BUS. ORGS. CODE ANN. § 21.909).

[50] *Id*. (adding TEX. BUS. ORGS. CODE ANN. § 21.910).

[51] *Id*. (adding TEX. BUS. ORGS. CODE ANN. § 21.911(a)).

[52] *Id*. (adding TEX. BUS. ORGS. CODE ANN. § 21.911(c)).

[53] *Id*. (adding TEX. BUS. ORGS. CODE ANN. § 21.911(e)).

[54] *Id*. (adding TEX. BUS. ORGS. CODE ANN. § 21.911(d)).

[55] *Id*. (adding TEX. BUS. ORGS. CODE ANN. § 21.914(a) and (b)).

and validating and declaring effective any defective corporate act or putative shares, among other things.[56] New Subsection 21.914(d) specifies various factors for the district court to consider in connection with the resolution of matters.

The district court is vested with exclusive jurisdiction to hear and determine all actions brought under Section 21.914.[57] Service of the application made to the district court may be made upon the registered agent of the corporation, and the district court may require a notice of the action to be provided to other persons to permit such other persons to intervene in the action.[58] A time limit of 120 days after the validation-effective time is established for any action asserting that a ratification by the corporation's board of directors in accordance with Section 21.903 is void or voidable due to a failure of authorization in accordance with that section or that the district court should declare in its discretion that a ratification in accordance with Subchapter R not take effect or should take effect only on certain conditions.[59] This time limit does not apply to an action asserting that a ratification was not accomplished in accordance with Subchapter R or to any person to whom notice of ratification was not given as required by Section 21.906 and 21.911.[60]

V. TERM OF SHAREHOLDERS' AGREEMENTS

S.B. 860 removes the antiquated ten-year time limit on the valid duration of shareholders' agreements under Subchapter C of Chapter 21. The ten-year time limit is retained for those shareholders' agreements that were in effect prior to the effective date of the amendment (September 1, 2015).[61] This provision is modeled on recently amended Section 7.32 of the MBCA.

VI. AUTHORIZING SHAREHOLDER ACCESS TO PROXY STATEMENTS

S.B. 860 adds provisions that expressly authorize bylaws of for-profit corporations to allow shareholder access to proxy statements.[62] These provisions specify that the bylaws of a for-profit corporation may contain a provision requiring the corporation to include in its proxy statement, when soliciting proxies or consents with respect to the election of directors, one or more individuals nominated by a shareholder in addition to individuals nominated by the board of directors, subject to such procedures or conditions as may be provided in the bylaws. In addition, the bylaws may contain a provision requiring that the corporation reimburse a shareholder's expenses in soliciting proxies or consents with respect to an election of directors, subject to such procedures and conditions as provided in the bylaws. These bylaw provisions are entirely elective, and not mandatory, on the part of a for-profit corporation and its board of directors. These provisions are conceptually similar to provisions recently added to the MBCA and DGCL.

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[56] *Id*. (adding TEX. BUS. ORGS. CODE ANN. § 21.914(c)).

[57] *Id*. (adding TEX. BUS. ORGS. CODE ANN. § 21.915).

[58] *Id*. (adding TEX. BUS. ORGS. CODE ANN. § 21.916).

[59] *Id*. (adding TEX. BUS. ORGS. CODE ANN. § 21.917(b)).

[60] *Id*. (adding TEX. BUS. ORGS. CODE ANN. § 21.917(a)).

[61] *Id.* § 23 (amending TEX. BUS. ORGS. CODE ANN. § 21.102).

[62] *Id.* § 25 (adding TEX. BUS. ORGS. CODE ANN. § 21.371(d)).

VII. COMBINED TENDER OFFER AND SHORT-FORM MERGER

S.B. 860 adds new authorization for the acquisition of a Texas public for-profit corporation, whose shares are listed on a national securities exchange or are held of record by more than 2,000 holders, through a "two-step" tender or exchange offer and merger process.[63] The process consists of a "front-end" tender or exchange offer for the public corporation's shares by the acquirer followed by a "back-end" merger between the acquirer and the public corporation. If the conditions stated in new Section 21.459(c) are met, the back-end merger may be effected without a shareholder vote or consent regarding the merger. The key conditions include:

1. The plan of merger must require or permit reliance on Section 21.459(c).

2. When the tender or exchange offer is consummated, the acquirer must own, by acquisition through the offer or otherwise, the number or percentage of the shares, and of each class or series of those shares, that would be necessary under the Code and the certificate of formation to approve a merger at a shareholders' meeting of the for-profit corporation.[64]

3. The holders whose shares are converted and exchanged in the merger must be entitled to receive the same consideration as the holders who tendered shares to the acquirer in the tender or exchange offer.

4. The merger must be effected as soon as practicable after the tender or exchange offer is consummated.[65]

This new type of merger, which applies only to Texas public for-profit corporations, is in addition to the existing right of an acquirer under Section 10.006 to effect a "short-form" merger without a shareholder vote or consent when the acquirer owns at least 90% of the outstanding shares of the corporation. New definitions are added for "consummates," "consummation," "consummating," "depositary" and "received" for purposes of Section 21.459(c) and certain newly revised sections of Chapter 10 regarding the dissenters' rights that apply to a back-end merger.[66] The new provisions added to Code Section 21.459 are based on Section 251(h) of the DGCL as adopted in 2013 and amended in 2014.

Corresponding amendments were also made to various Chapter 10 provisions to confirm that dissenters' rights apply to a back-end merger under Section 21.459(c). S.B. 860 amends Section 10.354(c) to state that the exception from dissenters' rights provided in Section 10.354(b), which applies to a merger (or an interest exchange or a conversion) involving a Texas public corporation described in that subsection, does not apply to a back-end

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[63] *Id.* § 26 (adding TEX. BUS. ORGS. CODE ANN. § 21.459(c), (d), (e)).

[64] Under the Code, in general terms, the vote or consent of two-thirds of the outstanding shares of a Texas for-profit corporation is required to approve a merger, though the corporation's certificate of formation may reduce that threshold to as little as a majority of the outstanding shares. *See* TEX. BUS. ORGS. CODE ANN. § 21.457.

[65] *Id.* § 26 (adding TEX. BUS. ORGS. CODE ANN. § 21.459(c)).

[66] *Id.* (adding TEX. BUS. ORGS. CODE § 21.459(d)).

merger effected under Section 21.459(c).[67] The responsible organization is required to notify the shareholders who have dissenters' rights of their rights at any time before, but no later than ten days after, the effective date of the merger. If the notice is given after the effective date of the merger, the notice must state the effective date of the merger.[68] If the notice is given before the effective date of the merger, a second notice must be given after the effective date of the merger stating the effective date of the merger.[69] The shareholders to whom the first and any second notice of dissenters' rights regarding a back-end merger subject to Section 21.459(c) must be given are described in the revised provisions. Such shareholders will vary depending on whether the relevant notice is given before or after the consummation of the front-end tender or exchange offer.[70] Another new provision describes the deadline for a dissenting shareholder's delivery of a demand to the organization responsible for dissenters' rights regarding such a back-end merger.[71] The deadline is the later of (a) the 20th day after the date the responsible organization gives to the shareholder the initial required notice of the right to dissent to the plan of merger or (b) the date of the consummation of the tender or exchange offer.

VIII. ADOPTION OF CERTAIN CORPORATE NAME AMENDMENTS

S.B. 860 authorizes the board of directors of a for-profit corporation, without shareholder approval, to adopt an amendment to the corporation's certificate of formation to change a word or abbreviation in its corporate name required by Section 5.054(a) to be a different word or abbreviation required by that section.[72] For example, the board of directors could authorize an amendment that changes the word "Inc." to "Corporation" in the corporate name without shareholder approval as a result of this amendment.

IX. EXECUTION OF CERTAIN FILING INSTRUMENTS BY ORGANIZERS OR DIRECTORS OF FOR-PROFIT CORPORATION

S.B. 860 adopts amendments to provide more flexibility by broadening the exception to the requirement that a certificate of amendment or a restated certificate of formation of a for-profit corporation must be signed by an officer of the corporation. If shares of the corporation have not been issued and the certificate of amendment or restated certificate of formation is adopted by the board of directors, then one or more of the directors, instead of a majority of the directors, may sign such a filing instrument.[73] Language is also added that references to Title 2 of the Code as containing a second exception to such general rule of officer execution. This exception is now found in new subsection (b) of Section 20.001, which authorizes an organizer or a director, rather than an officer, to sign a certificate of termination, a certificate of reinstatement, and a certificate of amendment to cancel an event requiring winding up or a restated certificate of formation that contains an amendment to cancel an event requiring winding up, in each case that is filed before the for-profit corporation commences business.

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[67] *Id.* § 15 (amending TEX. BUS. ORGS. CODE § 10.354(a), (c)).

[68] *Id.* § 16 (adding TEX. BUS. ORGS. CODE ANN. § 10.355(b-1)).

[69] *Id.* (adding TEX. BUS. ORGS. CODE ANN. § 10.355(f)).

[70] *Id.* (adding TEX. BUS. ORGS. CODE ANN. §§ 10.355(b)(3), (f)).

[71] *Id.* § 17 (adding TEX. BUS. ORGS. CODE ANN. § 10.356(b)(3)(E)(iv)).

[72] *Id.* § 21 (adding TEX. BUS. ORGS. CODE ANN. § 21.053(c) and amending § 21.053(a)).

[73] *Id.* §§ 2–3 (amending TEX. BUS. ORGS. CODE ANN. §§ 3.054, 3.060(b)).

The authority to sign corresponds with the authority of organizers or directors of a for-profit corporation, without shareholder approval, to approve a winding up, a reinstatement or a cancellation of an event requiring winding up under existing Section 21.502(2). Section 21.502(2) only applies if the corporation has not commenced business and has not issued any shares.

X. POWER OF SHAREHOLDERS OR ORGANIZERS TO CANCEL EVENT REQUIRING WINDING UP

S.B. 860 clarifies that action by the board of directors is not required for an amendment to a certificate of formation to cancel an event requiring winding up that is adopted or authorized by all of the shareholders or a majority of the organizers of a for-profit corporation under Section 21.502(1) or Section 21.502(2), respectively.[74] Such action may involve a certificate of amendment to a certificate of formation or a restated certificate of formation that contains an amendment to the certificate of formation. Section 21.502(2) only applies if the corporation has not commenced business and has not issued any shares. A corresponding amendment recognizes that a restated certificate of formation containing an amendment to cancel an event requiring winding up may be adopted or authorized by the shareholders or the organizers under Section 21.502(1) or Section 21.502(2), respectively.[75]

XI. WINDING UP OF INACTIVE NON-PROFIT CORPORATIONS

S.B. 860 makes several amendments that authorize the organizers and the board of directors of a nonprofit corporation that has no members or no members with voting rights to take the same actions before the nonprofit corporation holds or solicits any assets or otherwise engages in any activities as the organizers and the board of directors of a for-profit corporation may take under Code Section 21.502(2) before a for-profit corporation commences business and issues shares. A majority of the organizers or a majority of the directors, before the nonprofit corporation holds or solicits any assets or otherwise engages in any activities, may adopt a resolution to wind up, reinstate, cancel an event requiring winding up, revoke a voluntary decision to wind up, or effect a distribution plan for the corporation.[76] Another amendment specifies that, if a majority of the organizers or a majority of the directors approves the winding up, the reinstatement or the cancelation of an event requiring winding up, then the certificate of termination, certificate of reinstatement, certificate of amendment to cancel event requiring winding up or restated certificate of formation that contains an amendment to cancel an event requiring winding up may be signed by one of the organizers or one of the directors, as applicable.[77]

A corresponding amendment is made with respect to the "fundamental actions" of a nonprofit corporation.[78] If the nonprofit corporation has no members or no members with voting rights and has no assets and has not solicited any assets or otherwise engaged in any activities, the affirmative vote of a majority of the organizers or a majority of the directors is

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[74] *Id*. § 20 (adding TEX. BUS. ORGS. CODE ANN. § 21.052(d)).

[75] *Id*. § 22 (adding TEX. BUS. ORGS. CODE ANN. § 21.056(a)(2)).

[76] *Id*. § 29 (adding TEX. BUS. ORGS. CODE ANN.§ 22.302(1)(B)).

[77] *Id*. § 19 (amending TEX. BUS. ORGS. CODE ANN. § 20.001).

[78] *Id*. § 28 (adding TEX. BUS. ORGS. CODE ANN. § 22.164(d)).

required to approve a fundamental action consisting of an amendment to the certificate of formation to cancel an event requiring winding up or to approve any of the fundamental actions described in subsections (a)(2) through (a)(6) of Section 22.164.[79]

Another amendment specifies that the members or organizers of a nonprofit corporation have authority, without action of the board of directors, to approve a restated certificate of formation that contains an amendment to the certificate of formation to cancel an event requiring winding up under existing Section 22.302(2) and new Section 22.302(1)(B).[80]

XII. REPLACEMENT OF ANNUAL REGISTRATION REQUIREMENT FOR LLPS

In substantive amendments to Subchapter J of Code Chapter 152, S.B. 859 eliminates the antiquated requirements for a limited liability partnership to file an annual renewal of registration. The amendments adopt the more modern approach of Delaware and the majority of states to require limited liability partnerships to file an annual report. The requirement for, and the contents of, the new annual report are specified in new Section 152.806(a). The new annual report must specify the name of the partnership and the number of partners of the partnership as of the date of filing of the report.[81] The fees required to be paid in connection with the annual report are the same as for the previously required annual renewal of registration.[82]

The due date for filing of the annual report is June 1 of each year following the year of effectiveness of the application for registration.[83] The failure to file the annual report and pay the required fee by May 31 of the year following the year in which the annual report was due will result in automatic termination of the partnership's registration.[84] The Secretary of State is required to provide each limited liability partnership that has an effective registration as of December 31 of the preceding year a written notice not later than March 31 stating the due date of the annual report and the filing fee and that the registration of the partnership will be terminated unless the report and the filing fee are timely filed and paid.[85]

The termination of registration of the limited liability partnership does not constitute an event requiring winding up of the partnership under Code Chapter 11.[86] The amendments also provide procedures by which a partnership whose registration has been terminated may apply for reinstatement of its registration within three years after the date of termination.[87]

Existing provisions are also amended to reflect the change from an annual renewal-of-registration requirement to an annual report requirement for domestic limited liability

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79 *Id*.

80 *Id*. § 27 (amending TEX. BUS. ORGS. CODE ANN. § 22.109(a)).

81 S.B. 859 § 5 (adding TEX. BUS. ORGS. CODE ANN. § 152.806(a)).

82 *Id*. § 1 (amending TEX. BUS. ORGS. CODE ANN. § 4.158(2)).

83 *Id*. § 5 (adding TEX. BUS. ORGS. CODE ANN. § 152.806(a)).

84 *Id*. (adding TEX. BUS. ORGS. CODE ANN. § 152.806(c)).

85 *Id*. (adding TEX. BUS. ORGS. CODE ANN. § 152.806(b)).

86 *Id*. (adding TEX. BUS. ORGS. CODE ANN. § 152.806(d)).

87 *Id*. (adding TEX. BUS. ORGS. CODE ANN. § 152.806(e)–(g)).

partnerships. In Code Section 152.802, subsection (g) is deleted[88] and subsections (c) and (e) are amended to eliminate the renewal-of-registration requirement.[89] In several places, the word "revoked" is amended to read "terminated" to harmonize with the revised language.[90] To mitigate potential liability problems arising from minor compliance errors, the amendments clarify that the acceptance by the Secretary of State of an application for registration is conclusive evidence of the satisfaction of all conditions precedent to an effective registration and that the registration remains effective so long as there is substantial compliance with the registration and annual reporting requirements of Sections 152.802 and 152.806.[91]

Unlike the rest of S.B. 859, the limited liability partnership amendments take effect on January 1, 2016 to allow time for the Secretary of State to amend its systems and forms to accommodate the replacement of the annual registration requirement for domestic limited liability partnerships with an annual report requirement.[92]

XIII. PUBLIC INFORMATION REPORTS FOR PROFESSIONAL ASSOCIATIONS AND LIMITED PARTNERSHIPS

H.B. 2891 amends the Code and the Tax Code to make professional associations and limited partnerships subject to the annual public information reports that are required to be filed with the Texas Comptroller under Tax Code Section 171.203.[93] Effective January 1, 2016, limited partnerships and professional associations will be required to file the same public information report that corporations and limited liability companies have been required to file with the Texas Comptroller for many years. The Code's requirement for a professional association to file an annual statement with the Texas Secretary of State has been deleted.[94] The Code's requirement for a limited partnership to file a report not more than once every four years with the Texas Secretary of State is no longer applicable to any limited partnership that is required to file the public information report under Tax Code Section 171.203.[95]

The public information report required under the Tax Code requires, in a manner similar to requirements for corporations and limited liability companies, (a) the name of each corporation, limited liability company, limited partnership or professional association in which the limited partnership or professional association owns a 10% or greater interest or that owns a 10% or greater interest in the limited partnership or professional association filing the report, (b) the name, title and mailing address of each person who is an officer or director of the professional association, (c) the name and address of the agent of the limited partnership or professional association designated under Tax Code Section 171.354, and (d) the address of the principal office and principal place of business of the limited partnership or professional association.[96] For limited partnerships, in lieu of providing the identity of the officer or

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[88] *Id*. § 10.

[89] *Id*. § 4 (amending TEX. BUS. ORGS. CODE ANN. § 152.802(c), (e)).

[90] *Id*. (amending TEX. BUS. ORGS. CODE ANN. § 152.802(e), (h)).

[91] *Id*. (adding TEX. BUS. ORGS. CODE ANN. § 152.802(C-1), (k)).

[92] *Id*. §§ 4, 5, 11.

[93] H.B. 2891 § 3 (amending TEX. TAX CODE ANN. § 173.203(a)–(b)).

[94] *Id*. § 1 (amending TEX. BUS. ORGS. CODE ANN. § 4.156).

[95] *Id*. § 2 (amending TEX. BUS. ORGS. CODE ANN. § 153.301).

[96] *Id*. § 3 (amending TEX. TAX CODE ANN. § 173.203(a)).

director, the name, title and mailing address of each general partner of the limited partnership must be provided in the public information report. An officer or director of the professional association or a general partner of the limited partnership must sign the report under a specified certification.[97]

XIV. ENFORCEABILITY OF POWERS OF ATTORNEY IN GOVERNING DOCUMENTS

Powers of attorney are frequently included in limited liability company agreements, partnership agreements and related documents. S.B. 859 makes several amendments to clarify the enforceability of irrevocable power-of-attorney provisions relating to the organization, internal affairs or termination of a limited liability company, general partnership or limited partnership.[98] The new provisions also apply to (1) a power of attorney granted by a partner of a partnership, a transferee or assignee of a partnership interest in the partnership or a person seeking to become a partner of a partnership or a transferee or assignee of a partnership interest in a partnership, or (2) a power of attorney granted by a member of a limited liability company or assignee of a membership interest in the limited liability company or a person seeking to become a member of or assignee of a membership interest in a limited liability company.[99] A power of attorney is irrevocable for all purposes under the new provisions if the power of attorney is coupled with an interest sufficient in law to support an irrevocable power and states that it is irrevocable.[100] A power of attorney granted to the limited liability company or the partnership, or a member of the company, a partner of the partnership or the respective officers, directors, managers, members, partners, trustees, employees or agents of the company or the partnership is conclusively presumed to be coupled with an interest sufficient in law to support the irrevocable power.[101] The irrevocable power of attorney is not affected by the subsequent death, disability, incapacity, winding up, dissolution, termination of existence or bankruptcy of or any other event concerning the principal, unless otherwise provided in the power of attorney.[102] The new provisions are modeled after provisions added to the Delaware Limited Liability Company Act, the Delaware Revised Uniform Partnership Act and the Delaware Revised Uniform Limited Partnership Act in 2010.

XV. SERIES OF ENTITY TREATED AS PERSON UNDER TEXAS UCC

S.B. 1077 amended Chapter 1 of the TBCC to clarify that the definition of the term "person" includes a particular series of a for-profit entity.[103] This change confirms that a series of a Texas limited liability company can enter into contracts relating to the sale and lease of goods and other transactions that are subject to the Uniform Commercial Code as adopted in Texas in the TBCC. This change conforms to the intent of the authority granted to a series of a Texas limited liability company by Section 101.605 of the Code.[104] The amendment also is

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[97] *Id.* (amending TEX. TAX CODE ANN. § 173.203(d)).

[98] S.B. 859 §§ 2, 7 (adding TEX. BUS. ORGS. CODE ANN. §§ 101.055, 154.204).

[99] *Id.* (adding TEX. BUS. ORGS. CODE ANN. §§ 101.055(a), 154.204(a)).

[100] *Id.* (adding TEX. BUS. ORGS. CODE ANN. §§ 101.055(b), 154.204(b)).

[101] *Id.* (adding TEX. BUS. ORGS. CODE ANN. §§ 101.055(d), 154.204(d)).

[102] *Id.* (adding TEX. BUS. ORGS. CODE ANN. §§ 101.055(c), 154.204(c)).

[103] S.B. 1077 § 1 (amending TEX. BUS. & COM.. CODE ANN. § 1.201(b)(27)).

[104] TEX. BUS. ORGS. CODE ANN. § 101.605 provides that a series has the power and capacity, in the series' own

intended to apply to a series of a for-profit entity formed under the laws of another state. As a result, any particular series of a foreign for-profit entity is also considered a "person" for purposes of the chapters of the TBCC consisting of the Uniform Commercial Code. There are other states that authorize creation of series of business trusts and limited partnerships in addition to limited liability companies. Limited liability companies are the only type of Texas domestic entities that are specifically authorized by the Code to have series with liability limitations.[105]

XVI. NOTARIZED CONSENT TO USE OF SIMILAR NAME

S.B. 1313 amends the Code to require consents to use of similar entity names in certain filings with the Secretary of State to be notarized and delivered to the Secretary of State. The prohibitions contained in several sections of the Code against reservation or registration of a name with the Secretary of State when a similar name is already reserved or registered by another entity or person do not apply if that other person or entity provides to the Texas Secretary of State a notarized written statement of the consent of such entity or person to the use of the similar name.[106] Similarly, the other entity or person for whom a name is reserved or registered can consent by providing to the Texas Secretary of State a notarized written statement of the consent to use of a similar name in the formation of a new domestic filing entity or the registration to transact business of a foreign filing entity.[107] In each case, these written consents were not previously required to be notarized or specifically required to be provided to the Texas Secretary of State. Nevertheless, the Texas Secretary of State has in practice required evidence of the consent to be filed in connection with the certificate of formation, application for registration to transact business or new name registration or reservation before accepting such filings.

XVII. OTHER MINOR AMENDMENTS

S.B. 860 clarifies the definition of "existing claim" in Chapter 11 of the Code by conforming it to the predecessor statutory provision, Article 7.12.F(3) of the TBCA.[108] This change makes the definition consistent with usage of the term in other provisions of Chapter 11, such as Sections 11.356(a)(2) and 11.359(a).

S.B. 859 effects an amendment to clarify that Code Section 5.203 is another exception to the requirement that a limited partnership must amend its certificate of formation to reflect any change in the address of its registered office or the name or address of its registered agent.[109] Section 5.203 permits a registered agent to file an amendment to effect a change in its name or office address.

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name, to: (1) sue and be sued; (2) contract; (3) acquire, sell, and hold title to assets of the series, including real property, personal property, and intangible properties; (4) grant liens and security interests in assets of the series; and (5) exercise any power or privilege as necessary or appropriate to the conduct, promotion, or attainment of the business, purposes or activities of the series.

105 *See* TEX. BUS. ORGS. CODE ANN. § 101(m).

106 S.B. 1313 §§ 2–3 (amending TEX. BUS. ORGS. CODE ANN. §§ 5.102(b), 5.153(b)(1)).

107 *Id*. § 1 (amending TEX. BUS. ORGS. CODE ANN. § 5.053(b)).

108 S.B. 860 § 18 (amending TEX. BUS. ORGS. CODE ANN. § 11.001(3)).

109 S.B. 859 § 6 (amending TEX. BUS. ORGS. CODE ANN. § 153.051(a)).

Another amendment makes clear that Section 11.057(f), which was added to the Code in 2011 and defines "majority-in-interest" for purposes relating to winding up a domestic general partnership, may be modified by the partnership agreement.[110]

S.B. 859 repeals Code Section 101.351 because the provision is not essential and creates the possibility of confusion regarding the interpretation of some of the provisions of Subchapter H of Chapter 101.[111] Section 101.351 provided that Subchapter H applied only to a meeting of and voting by the governing authority, the members if the members do not constitute the governing authority and a committee of the governing authority of a limited liability company. That limited applicability is inaccurate because Subchapter H applies to matters other than meeting of or voting by the governing authority (or a committee thereof) or the members of the limited liability company.

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110 *Id*. § 3 (amending TEX. BUS. ORGS. CODE ANN. § 152.052(b)(9)(D)).

111 *Id*. § 9.

CHOICE-OF-LAW PROVISIONS AND THE ROLE OF BUSINESS RELATIONSHIPS TO OTHER JURISDICTIONS WITH RESPECT TO DETRIMENTAL-ACTIVITY CLAUSES IN EXECUTIVE COMPENSATION PLANS

By Allen Bywaters Landon*

Exxon Mobil Corp. v. Drennen, 452 S.W.3d 319 (Tex. 2014).

In *Exxon Mobil Corp. v. Drennan*, the Supreme Court of Texas reversed the court of appeals' judgment in favor of a former executive, William Drennan, III, ("Drennan") and rendered a judgment for Exxon Mobil ("Exxon").[1] The dispute between the parties arose from an executive compensation plan, which included a contractual choice-of-law provision designating that New York law would apply as well as a provision for forfeiture of the executive's bonus awards in the event he engaged in "detrimental activity."[2] The Court concluded that Exxon's basis for choosing New York law, the goal of uniformity, was logical[3] and reasonable,[4] both Texas and New York bear some relationship to the parties and the transaction,[5] the forfeiture provision was not a covenant not to compete,[6] and that, under Texas law, application of New York law would not contravene Texas policy;[7] thus, the Court was bound to enforce the contractual choice-of-law provision and apply New York Law.[8] New York permits enforcement of similar detrimental-activity provisions to employment contracts, so the provision would be enforced without regard to whether Texas law would permit such.[9]

I. Background.

Mr. Drennen was an employee of Exxon for approximately thirty one years spanning from 1976 to 2007.[10] Drennen's work throughout his career with Exxon was as a geologist and his final title before retirement was Exploration Vice President of the Americas.[11] During his employment with Exxon, Drennen signed incentive compensation programs in 1993 and 2003, and these programs awarded bonuses, restricted stock options, and earnings bonus units.[12] Both parties executed the incentive program agreements in Texas.[13] Each of the program agreements included choice-of-law provisions indicating New York law would apply, and termination provisions enabling Exxon to "terminate outstanding incentive awards if the employee (1) engaged in a detrimental activity, or (2) left" Exxon by resignation or abnormal

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1 Exxon Mobil Corp. v. Drennen, 452 S.W.3d 319, 332 (Tex. 2014).

2 *Id.* at 321.

3 *Id.* at 332.

4 *Id.* at 325.

5 *Id.* at 324.

6 *Id.* at 329.

7 *Id.* at 330.

8 *Id.* at 331.

9 *Id.* at 332.

10 *Id.* at 322.

11 *Id.*

12 *Id.*

13 *Id.*

form of termination.[14] The programs further defined detrimental activity in 1993 as "activity that is determined in individual cases by the administrative authority to be detrimental to the interest of the Corporation of any affiliate," and in 2003 as "acceptance . . . of duties to a third party under circumstances that create a material conflict of interest" including when the recipient becomes employed by an entity that "regulates, deals with, or competes with" Exxon or its affiliates.[15]

After receiving an unfavorable annual performance review in the midst of a new C.E.O.'s push to promote younger vice presidents, Drennen learned from his supervisor, Tim Cejka, that "so long as he did not go to work for one of the other four "majors" (Shell, BP, ChevronTexaco, or ConocoPhilips), he would [not lose his unvested options]" should Drennen leave Exxon.[16] The next year, after already receiving 16,700 shares of unrestricted stock and cashing out $4 million in pension funds, $1.8 million in 401(k) funds, and $3 million in stock options throughout his employment to that point, Drennen retired from Exxon with 57,200 shares still held within their restriction period.[17] Despite being warned by Cejka that if he took a position with Hess Corporation he would likely lose all his remaining incentives, Drennen began working at Hess as Senior Vice President for Global Exploration and New Ventures in July 2007.[18] Soon after, Cejka notified Drennen of cancellation of his remaining incentive awards due to the fact Hess is a direct competitor of Exxon, constituting a material conflict of interest or "detrimental activity" under both incentive plans.[19]

Drennen sued to recover the stock Exxon claimed he forfeited, seeking judgment that:

> (1) the detrimental-activity provisions in the Incentive Programs were being utilized as covenants not to compete; (2) the covenants not to compete are unenforceable because they are not limited as to time, geographic area, or scope of activity; and (3) therefore, ExxonMobil's cancellation of the restricted shares and bonus units was an impermissible attempt to recover monetary damages for an alleged breach of an unenforceable covenant not to compete.[20]

Drennen also claimed breach of oral contract regarding the earlier conversation with Cjeka that Drennen could retain awards as long as he did not work for one of the four majors, asserted the written program agreements had been modified by this oral statement, and raised an estoppel or waiver argument based on the assertion by Cjeka.[21] The jury found for Exxon on all claims, so Drennen moved for judgment notwithstanding the verdict ("JNOV"), which was denied by the trial court.[22]

Following denial of the JNOV, Drennen appealed arguing Texas public policy prohibits

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[14] *Drennen*, 452 S.W.3d at 322.
[15] *Id.*
[16] *Id.*
[17] *Id.* at 323.
[18] *Id.*
[19] *Id.*
[20] *Id.*
[21] *Id.*
[22] *Id.*

enforcement of detrimental-activity provisions because they constitute void covenants not to compete.[23] The 14th District Court of Appeals reversed and ordered the trial court to render a declaratory judgment for Drennen, holding that the forfeiture provisions were unreasonable covenants not to compete and thus unenforceable under Texas law as a matter of public policy.[24] Because applying New York law would lead to a result against Texas public policy, the Court of Appeals found the choice-of-law provision unenforceable; therefore, Texas law applied and the detrimental-activity provisions were unenforceable.[25]

II. Texas Supreme Court Analysis.

After Exxon appealed to the Supreme Court of Texas, the Court applied an analysis modeled after the Restatement (Second) Conflict of Laws,[26] which involved considering the enforceability of the choice-of-law provisions by investigating whether New York had a sufficiently close relationship to the parties and the contract to make the choice of New York law reasonable,[27] whether Texas or New York had the more significant relationship to the parties and the contract,[28] which state had a materially greater interest in the matter,[29] and whether the application of New York law would be contrary to a fundamental policy of Texas.[30] This analysis was similarly used in 1990 by the Court in *Desantis v. Wackenhut Corp*.[31] After noting that Texas law recognizes that parties can agree to be governed by the law of another state,[32] the Court indicated that parties' choice of such law must have some "sufficiently close" relation to the parties and their agreement to render the choice reasonable.[33] The Court also indicated that the other potential reason to void a choice-of-law provision would be if application of that law is contrary to fundamental policy of a state with a materially greater interest than the state chosen.[34]

Drennen worked in Houston when each of the incentive program agreements were signed,

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[23] *Drennen*, 452 S.W.3d at 323.

[24] *Id.*

[25] *Id.* at 323–24.

[26] The law of the state chosen by the parties to govern their contractual rights and duties will be applied, even if the particular issue is one which the parties could not have resolved by an explicit provision in their agreement directed to that issue, unless either

(a) the chosen state has no substantial relationship to the parties or the transaction and there is no other reasonable basis for the parties' choice,

or

(b) application of the law of the chosen state would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issue and which, under the rule of § 188, would be the state of applicable law in the absence of an effective choice of law by the parties.

RESTATEMENT (SECOND) CONFLICT OF LAWS § 187(2) (1971).

[27] *Drennen*, 452 S.W.3d at 324–25 (Tex. 2014).

[28] *Id.* at 325–26.

[29] *Id.* at 326–27.

[30] *Id.* at 327–30.

[31] *Id.* at 324. *See also* DeSantis v. Wackenhut Corp., 793 S.W.2d 670, 677 (Tex. 1990).

[32] *Drennen*, 452 S.W.3d at 324.

[33] *Id.* at 324–25.

[34] *Id.* at 325.

but during his time working for Exxon he also spent three years working in New York City.[35] Exxon is headquartered in Texas, but their outside counsel is a firm in New York City and the shares in question are traded on the New York Stock Exchange ("NYSE") in New York City.[36] Exxon claimed choosing New York law was reasonable on the basis of assuring uniformity, certainty, and predictability in the application of its incentive programs; because such awards are provided to numerous employees in multiple places throughout the United States and the world, there is a good likelihood for those employees to relocate throughout their careers.[37] Additionally, the stock which is the subject of the incentives is listed on the NYSE.[38] New York law regarding employee stock incentive programs is well-developed and predictable, "making it a routine choice of law for parties to stock-related transactions and agreements."[39] Considering the above facts and arguments as well as the low likelihood parties would designate such a provision without reason, the Court concluded that the choice of New York law was enforceable.[40]

The next *DeSantis* consideration the Court applied was whether, absent an effective choice-of-law, there is a state with a more significant relationship to the parties and the transaction than New York.[41] To make this determination, the Court factored the location of the execution of the agreement, the locations of the parties, the location of negotiations, and the place of performance.[42] The agreements were both executed in Texas, both parties are located in Texas, and the negotiations as well as performance of the contract took place in Houston and Irving, Texas.[43] Comparatively, Drennen did work for three years in New York and Exxon has a presence in New York.[44] The Court indicated that the parties and the transaction bear relations to both states, but after considering the interests the Court concluded that Texas has a more significant relationship.[45]

The Court then analyzed whether Texas has a materially greater interest in determining the enforceability of detrimental activity provisions, because if it does not have a greater interest then it is immaterial whether New York law application is contrary to fundamental Texas policy.[46] In *DeSantis*, the Court held that Texas clearly had a materially greater interest in whether the agreement should be enforced, because the plaintiff was an employee in Texas, the defendant was a national employer doing business in Texas, the plaintiff formed a new business in Texas in violation of a non-compete provision, and Texas was concerned with how non-compete agreements affected consumers of services in Texas.[47] Exxon argued that Texas has no materially greater interest than New York in enforceability, because the choice-of-law

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35 *Drennen*, 452 S.W.3d at 324.

36 *Id.*

37 *Id.* at 325.

38 *Id.*

39 *Id.*

40 *Id.*

41 *Id.* at 325–26.

42 *Id.* at 326.

43 *Id.*

44 *Id.*

45 *Id.*

46 *Id.*

47 *Drennen*, 452 S.W.3d at 326.

provision was made for uniformity and predictability.[48] That argument failed, because despite there being interests in protecting justifiable expectations of entities doing business in multiple states, those external interests do not outweigh Texas's.[49] Additionally, the *DeSantis* employer was Floridian, but the Court concluded Texas had a materially greater interest, so in this case where both parties were Texas residents the Court indicated it must favor Texas over New York for such interest.[50]

The last step in the Court's analysis was to determine whether fundamental policy of Texas would disfavor applying New York law.[51] Without defining "fundamental policy," the Court indicated that it would be necessary to "determine whether the provisions at issue in the [i]ncentive [p]rograms are covenants not to compete."[52] Texas generally defines covenants not to compete as obligations that limit former employees' work mobility or restrict solicitation of former customers, which are trade restraints governed by the Covenants Not to Compete Act.[53] The incentive program agreements did not limit the professional mobility of Drennen *per se*, so the Court indicated the agreements in question did not "fit the mold."[54]

A narrow but important difference was present: non-competition provisions protect the investment of an employer in an employee, while forfeiture provisions conditioned on loyalty reward that loyalty but do not restrict employee future employment.[55] Furthermore, a former employer can file suit for breach of contract to enforce a non-competition clause, but a former employer does not have to take any legal action under a forfeiture provision, because the employer owns the profit-sharing plan.[56] The detrimental activity provisions in the incentive programs were deemed different from non-competition provisions in key Texas non-competition cases, such as *DeSantis*.[57] Drennen agreed that he would receive bonus compensation for his hard work in the form of stock, not that he would refrain from soliciting clients or employees or not compete with Exxon all-together.[58] This agreement between Drennen and Exxon carried a condition of continued loyalty, which empowered Exxon to withhold restricted shares of bonus compensation if the employee chose to compete during the restricted phase period.[59] Instead of contracting that Drennen not compete, the incentive program agreements only force the employee to choose between accepting his retirement plan benefits he contributed nothing to or choose to compete with the former employer.[60] The Court therefore held that forfeiture clauses such as those present in the Exxon incentive plans are not covenants not to compete.[61]

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48 *Id.*

49 *Id.* at 326–27.

50 *Id.* at 327.

51 *Id.*

52 *Id.*

53 *Id.*

54 *Id.*

55 *Id.* at 327–28.

56 *Id.* at 328.

57 *Id.* at 328–29.

58 *Id.* at 329.

59 *Id.*

60 *Drennen*, 452 S.W.3d at 329.

61 *Id.*

The Court next turned its focus to public policy and conflict of laws by indicating that the policy concerns over uniformity of law in the *DeSantis* case time have changed over the past few decades.[62] Since Texas hosts many large corporations, its public policy has shifted to value the ability of a company to maintain uniform treatment of its employment contracts regardless of where the employees reside.[63] Such policy "prevents the disruption of orderly employer-employee relations . . . and avoids disruption to competition in the marketplace."[64] Given the scope and size of Exxon, the Court concluded that even if application of Texas or New York law were to reach different results on enforceability, it was not likely to constitute a determination contrary to fundamental Texas policy.[65] Furthermore, Texas will not refrain from applying a chosen law simply on the basis that the result would be different from an application of state law or otherwise applicable law.[66] The Court indicated it was bound to enforce the parties' choice-of-law provisions, because enforcement of New York law would not contravene Texas fundamental public policy.[67]

After concluding its analysis of enforceability of choice-of-law provisions and forfeiture provisions such as those found in the Exxon agreements, the Court considered the application of New York law to the facts of the case at hand.[68] A very similar case to *Exxon*, *Morris v. Schroeder Capital Management International*, was reviewed.[69] When a provision leaves the receipt of incentive rewards up to a choice of an employee, whether he chooses to not compete and receive the benefits or compete and decline the benefits, it is not an unreasonable restraint upon his ability to earn a living or his liberty.[70] Drennen agreed to the detrimental activity provisions in exchange for the compensation program benefits, and the provisions did not bar him from working elsewhere.[71] The detrimental activity provisions of the incentive programs gave Drennen the choice to preserve his right to the remaining 57,200 shares by complying or risk forfeiture of his rights by choosing to exercise his right to compete with Exxon.[72]

The Court indicated that if Exxon had terminated Drennen's employment without cause, then enforcement of the detrimental activity provisions would not be reasonable.[73] If Drennen voluntarily left or was terminated for cause, then the covenants would be enforceable regardless of reasonability and choice.[74] Drennen was told his performance was inadequate to continue his current position with Exxon, but the company would find another position for him.[75] Drennen then retired, "made an informed choice" to forfeit his outstanding awards by accepting employment with a competing company rather than retaining his awards by avoiding

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62 *Id.*

63 *Id.* at 330.

64 *Id.*

65 *Id.*

66 *Id.* at 331.

67 *Id.*

68 *Id.* at 331–32.

69 *Id.* at 331. *See also* Morris v. Schroeder Capital Management International, 859 N.E.2d 503 (N.Y. 2006).

70 *Drennen*, 452 S.W.3d. at 331.

71 *Id.* at 332.

72 *Id.*

73 *Id.*

74 *Drennen*, 452 S.W.3d at 332.

75 *Id.*

competition, and under New York law Exxon lawfully terminated Drennen's outstanding awards upon breach.[76]

III. Conclusion.

The Court reversed the court of appeals' judgment and applied New York law to reach its judgment for Exxon.[77] Its rationale was that uniformity is a logical basis for Exxon's choice of New York law as well as a valid goal the Restatement (Second) of Conflict of Laws §187 recognizes.[78]

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[76] *Id.*

[77] *Id.*

[78] *Id.*

LIABILITY OF A PARTNER—WHEN CAN YOU COLLECT FROM THE PARTNER IF THE PARTNERSHIP DOES NOT PAY?

By Erica J. Reyes*

Am. Star Energy & Mineral Corp. v. Stowers, 457 S.W.3d 427 (Tex. 2015).

In this case, a judgment creditor sought to collect the judgment from individual partners after the insolvent partnership judgment debtor could not pay.[1] The trial court found that American Star's claim was precluded by the statute of limitations, and the Amarillo Court of Appeals affirmed.[2] The issue in this review is "whether Texas Partnership law requires a plaintiff seeking to enforce a partner's liability for a partnership debt to sue the partner within the limitations period on the underlying claim against the partnership."[3] The Supreme Court holds that the limitations period against an individual partner does not begin until the final judgment against the partnership is entered.[4]

FACTS

The four respondents to this suit formed S & J Investments (S & J) in 1980 to invest in and manage oil and gas properties.[5] S & J executed an agreement with American Star Energy and Minerals Corporation (American Star), the other party to the suit, that governed the operation of the oil and gas properties.[6] Ten years later, American Star sued S & J for breach of the agreement, and American Star prevailed on these claims.[7] S & J's attempts at appealing the decision were not successful.[8]

S & J owes American Star $227,884.46 on the judgment American Star procured in the early 1990s.[9] S & J was undercapitalized, and its assets could not satisfy the judgment when American Star attempted to collect.[10] . American Star brought this action in 2010 seeking a judgment against the individual partners.[11] The Partners argued that the four year statute of limitations had run on the underlying breach of contract case, and therefore, American Star could not go after them individually.[12] The trial court ruled that the limitations period began when the underlying cause of action accrued, and the court of appeals affirmed the trial court's decision.[13] American Star sought supreme court review.[14]

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1 Am. Star Energy & Minerals Corp. v. Stowers, 457 S.W.3d 427 (Tex. 2015).

2 *Id.* at 428

3 *Id.*

4 *Id.*

5 *Id.*

6 *Id.*

7 *Id.*

8 *Id.* at 428–29.

9 *Am Star Energy*, 457 S.W.3d at 429.

10 *Id.*

11 *Id.*

12 *Id.*

13 *Id.*

14 *Id.*

ANALYSIS

In Texas, a partnership is an "entity distinct from its partners."[15] Texas adheres to the entity theory of partnership.[16] Under this theory, a partnership can do in its own name almost everything an individual can do, such as enter into contracts, own property, sue, and be sued.[17] Despite the entity theory, a partner is still jointly and severally liable for the obligations of the partnership.[18] This feature of the Texas partnership conforms with the aggregate theory of partnership.[19] The Texas Revised Partnership Act "imposes even on this aggregate feature an entity aspect."[20] A judgment against a partnership is not in and of itself a judgment against an individual partner.[21] A creditor must obtain a separate judgment against the individual partner. The creditor may not seek a judgment against a partner without first obtaining a judgment against the partnership.[22] The court concedes that this is arguably the most confusing aspect of partnership law.[23]

The applicable statute of limitations does not expressly dictate when a suit against an individual partner must be brought.[24] The Partners argue that American Star could have sued them in the original suit against the partnership, and because they could have done so, the cause of action accrued upon the breach of the underlying agreement.[25] Conversely, American Star argues that the Partners had no obligation until the judgment against the partnership became final, and thus, the limitations period did not begin until 2009.[26] The original action was against S & J. The Partners were not named individually, so they had no obligation to pay the judgment yet. When a partnership obligates itself to pay a sum or perform a service, the individual partners cannot be immediately called on to pay the sum, even though they are liable.[27] The claim must be litigated, a judgment must be secured against the partnership, and the ninety-day satisfaction period must have passed before an individual partner can become personally liable.[28] In a way, the partners are guarantors of the partnership, rather than being directly liable.[29] Furthermore, the Legislature considers a collection action a separate action from the original cause of action.[30] The Supreme Court ultimately holds "[i]n light of a partnership's status as a separate entity and the statutory prerequisites to proceeding against a partner. . . that the cause of action against a partner does not accrue until a creditor can proceed against a partner's assets—that is, generally at the expiration of the ninety-day satisfaction

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15 *Id.*
16 *Id.*
17 *Id.*
18 *Id.*
19 *Id.*
20 *Id.*
21 *Id.*
22 *Am. Star Energy*, 457 S.W.3d at 430.
23 *Id.*
24 *Id.*
25 *Id.*
26 *Id.*
27 *Id.* at 431.
28 *Id.*
29 *Id.*
30 *Id.* at 432.

period."[31]

The Partners argue that the judgment against a partner must be based on the same claim as the underlying case.[32] They argue that this collection suit is really a suit on the breach of contract suit, and the limitations period should have begun when the underlying cause of action accrued.[33] The Court swiftly rejects this, stating that this suit is to enforce liability not the underlying agreement.[34] The Court also notes that federal courts have reached the same conclusion.[35]

The Partners also contend that this collection suit imposes a type of automatic liability and infringes their due process rights.[36] The Court states that their liability is not automatic.[37] A suit such as this one is required in order to establish their liability.[38] The Partners have the opportunity to contest their liability, as they would if they had been sued under the underlying cause of action.[39] Furthermore, the Partners were on notice of potential liability when they chose to conduct business as a partnership.[40]

From a policy standpoint, the holding of this case avoids the injustice of a partner fully shielding himself from liability for the partnership's actions.[41] Someone choosing to do business with a partnership knows that the partnership assets are not the sole form of relief available if the partnership fails to perform their obligations.[42] On the same note, those who choose the partnership as their form of business entity are aware that their personal assets may be sought after for the partnership's failure to perform their obligations.[43] The court again fully rejects the Partners' arguments and holds that American Star's suit is not barred by the limitations period, reversing the court of appeals.[44]

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31 *Id.* at 431.
32 *Id.* at 433.
33 *Id.*
34 *Id.*
35 *Id.*
36 *Am. Star Energy*, 457 S.W.3d at 434.
37 *Id.*
38 *Id.*
39 *Id.*
40 *Id.*
41 *Id.* at 435.
42 *Id.*
43 *Id.*
44 *Id.*

LIFE SETTLEMENT AGREEMENTS AND THE TEXAS SECURITIES ACT: A SUMMARY AND REVIEW OF *LIFE PARTNERS, INC. V. ARNOLD*

By Joseph R. Anderson*

Life Partners, Inc. v. Arnold, 464 S.W.3d 660 (Tex. 2015).

I. Introduction

In *Life Partners, Inc. v. Arnold*,[1] the Texas Supreme Court (the Court) addressed the issue of whether "life settlement agreements" are securities under the Texas Securities Act and thus subject to the Act's registration and disclosure requirements.[2] Holding that the transactions at issue are in fact "investment contracts," and thus "securities," under the Texas Securities Act, the Court solidified important protections for the investing public and rejoined the vast majority of States in interpreting securities regulations broadly so as to maximize the protection provided to investors.[3] After briefly summarizing the law and facts at issue, this article discusses the Court's reasoning and analysis in *Life Partners* and attempts to address some potential impacts of the Court's decision.

II. The Law at Issue

In general, securities regulations "embody the belief that information is the most important form of investor protection."[4] The Texas Securities Act (the Act), in particular, requires that all securities be registered with the State and that all issuers or dealers have a permit to sell such securities.[5] Furthermore, before a permit can be granted, the Act requires that certain disclosures be made in a sworn and verified statement.[6] In addition to other information, the statement must include the following: the names and addresses of the officers of the company; the location of its principal place of business; copies of the securities to be sold; "a copy of any contract it proposes to make concerning such security"; a copy of any "advertisement or other description of security prepared"; and a number of the company's financial statements must be provided.[7]

Moreover, the Act also imposes civil liability on any "person who offers or sells" securities "by means of an untrue statement of a material fact or an omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under

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[1] 464 S.W.3d 660 (Tex. 2015).

[2] *Id.* at 662.

[3] *Id.* at 681.

[4] *Id.* at 676-77 (citing S.E.C. v. Life Partners, Inc., 87 F.3d 536, 550 (D.C. Cir. 1996) (Wald, J., dissenting)). [hereinafter *D.C. Cir. Life Partners*]

[5] Tex. Rev. Civ. Stat. Ann. art. 581-7.A(1) (West 2012) ("No dealer or agent shall sell or offer for sale any securities . . . , except those which shall have been registered . . . and . . . until the issuer of such securities or a dealer registered under the provisions of this Act shall have been granted a permit by the Commissioner . . . .").

[6] *Id.*

[7] *Id.*

which they are made, not misleading."[8] The provisions of this Act, however, only apply to sales and offers to sell "securities," as that term is defined in the Act. While the Act does provide that the "term 'security' or 'securities' shall include any . . . investment contract, or any other instrument commonly known as a security," the Act does not define the term "investment contract."[9] It has therefore been left to courts to determine which types of transactions fit within the meaning of the term "investment contract."[10]

The Texas Supreme Court first adopted the United States Supreme Court's *Howey*/*Forman* Test for determining whether a transaction constitutes an "investment contract" in *Searsy v. Commercial Trading Corp.*[11] There, the Court explained that the term "appear[ed] to have been taken from an almost identical definition of 'security' in the Federal Securities Act of 1933,"[12] and accordingly, the Court "looked to federal cases and other authorities for guidance in construing the term."[13] As the Court noted in *Searsy*, "[t]he *Howey* test embodies four requirements: (1) investment of money; (2) a common enterprise; (3) expectation of profits; (4) solely from the efforts of others."[14]

Before the Texas Supreme Court's holding in *Life Partners*, the Texas courts of appeals were in disagreement regarding the relevance of pre-purchase activities to this test and whether life settlement agreements were investment contracts under the Texas Securities Act.[15] This idea, however, is by no means a new concept. The Eleventh Circuit included life settlement agreements within the meaning of the term "investment contract" in 2005,[16] and in 2010, "the SEC issued a special report on life settlement contracts," which "[a]mong other things, . . . recommended that life settlements be clearly defined as securities."[17] The SEC report also noted that "[a]lmost all states treat life settlements as securities under state laws," and at that time, "[o]nly two states ha[d] not made a determination as to whether life settlements are

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[8] *Id.* art. 581–33.A(2). "In addition, the Act obligates the Attorney General 'to take such measures and to make such investigations as will prevent or detect the violation of any provision thereof.'" *Life Partners*, 464 S.W.3d at 666 n.7 (quoting art. 581-3).

[9] Art. 581-4.A.

[10] *See* Searsy v. Commercial Trading Corp., 560 S.W.2d 637, 639–41 (Tex. 1977).

[11] *Id.* at 641; *see also*, *Life Partners*, 464 S.W.3d at 670 ("When we addressed the meaning of 'investment contract' in *Searsy*, we adopted the Supreme Court's *Howey* test, as restated in *Forman*, as the basis for determining whether a transaction is an 'investment contract,' and thus a 'security,' under the Texas Securities Act.").

[12] *Searsy*, 560 S.W.2d at 639 (citing 15 U.S.C. § 77b(1)).

[13] *Id.* at 639–41. "American courts have thus developed a significant body of law on the topic, and while these courts have not always agreed, their decisions have served as a guide to the meaning and application of the term 'investment contract' in the securities-law context throughout the country." *Life Partners*, 464 S.W.3d at 667.

[14] *Searsy*, 560 S.W.2d at 640.

[15] In the cases before the Court in *Life Partners*, both the Dallas and Austin Courts of Appeals rejected the Waco court's conclusion, in Griffitts v. Life Partners, Inc., No. 10–01–00271–CV, 2004 WL 1178418, at *2 (Tex. App.—Waco May 26, 2004, no pet.) (mem. op.), that Life Partners' life settlement agreements were not investment contracts. Arnold v. Life Partners, Inc., 416 S.W.3d 577, 592 (Tex. App.—Dallas 2013), *aff'd*, 464 S.W.3d 660 (Tex. 2015); State v. Life Partners Holdings, Inc., 459 S.W.3d 619, 619 (Tex. App.—Austin 2014) (mem. op.), *aff'd sub nom.*, Life Partners, Inc. v. Arnold, 464 S.W.3d 660 (Tex. 2015).

[16] S.E.C. v. Mut. Benefits Corp., 408 F.3d 737, 744 (11th Cir. 2005).

[17] 1 Thomas Lee Hazen, The Law of Securities Regulation §1.6[2][D] (7th ed. 2012)

securities under state law."[18]

III. The Factual Background & Procedural History of *Life Partners, Inc. v. Arnold*

For more than 20 years, Life Partners, Inc. ("Life Partners") "has been engaged in the business of buying existing life insurance policies from those whose lives the policies insure, and then selling interests in those policies to others."[19] The Court in *Life Partners* refers to these types of transactions, in general, as "life settlement agreements."[20] Life Partners purchases insurance policies[21] from the insureds "for a 'cash settlement' that is less than the amount the policy will pay at the time of the insured's death."[22] It funds these transactions by selling "interests in the policies' future benefits to 'investors' or 'purchasers.'"[23] In particular, Life Partners uses the investors' funds to "(1) pay the insured for the policy, (2) create an escrow account from which to pay the policy's future premiums as they come due, (3) pay fees to escrow agents and to any brokers . . . , and (4) pay Life Partners an administration or brokerage fee."[24] Life Partners then becomes legal owner of the policy and "appoints a trustee to serve as the beneficiary."[25] Thus, the investors do not actually own or have control over the policies, and once the insured dies, Life Partners is responsible for obtaining the death certificate, submitting a claim to the life insurance company, and facilitating payment of the benefits, which are first paid to the trustee and then distributed "to the purchasers according to their fractional interests."[26]

The subject of these lawsuits is the transaction between Life Partners and the purchasers of these fractionalized interests, which the court refers to as "life settlement agreements."[27] The issue in these two consolidated cases then is "whether a 'life settlement agreement' . . . is an 'investment contract' and thus a 'security' under the Texas Securities Act."[28] In the first case, *Arnold v. Life Partners, Inc.*,[29] Michael and Janet Arnold, and other purchasers of these life settlement agreements, "filed a class action lawsuit in Dallas County, seeking rescission and damages based on claims that Life Partners . . . violated the Texas Securities Act by selling unregistered securities and materially misrepresenting to purchasers that they were not, in fact, securities."[30] In the second case, "*State v. Life Partners, Inc.*,[31] the State of Texas filed a

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[18] Life Settlements Task Force, S.E.C., Staff Report to the United States Securities and Exchange Commission 36 (July 22, 2010) [hereinafter SEC Report], http://www.sec.gov/news/studies/2010/lifesettlements-report.pdf.

[19] *Life Partners*, 464 S.W.3d at 663 ("These types of transactions are generally referred to as 'life settlements' when the insured is elderly or 'viatical settlements' when the insured is terminally ill.").

[20] *Id.*

[21] "When selecting policies to purchase, Life Partners identifies insureds who are interested in selling their policies, evaluates their medical condition, predicts their life expectancy, and evaluates the policies' terms and conditions to ensure they are assignable." *Id.* at 664.

[22] *Id.* at 663.

[23] *Id.*

[24] *Id.* at 664.

[25] *Id.*

[26] *Id.* at 665.

[27] *Id.* at 663. The transaction between Life Partners and the insureds is not at issue in these cases. *Id.*

[28] *Id.* at 662.

[29] Arnold v. Life Partners, Inc., 416 S.W.3d 577 (Tex. App.—Dallas 2013), *aff'd*, 464 S.W.3d 660 (Tex. 2015)

[30] *Life Partners*, 464 S.W.3d at 662 (footnote omitted) (discussing the facts of *Arnold*).

separate suit in Travis County, seeking an injunction and other relief based on allegations that Life Partners and others had committed fraud in connection with the sale of securities."[32] In both cases, the district courts granted summary judgments "in favor of Life Partners, holding that Life Partners had not promoted or marketed any 'securities' and thus could not be liable under the Texas Securities Act."[33]

IV. The Texas Supreme Court's Reasoning

The Court's decision in *Life Partners* is primarily based on a fundamental analysis and clarification of the term "investment contract," as used in the Texas Securities Act.[34] Relying heavily on the reasoning and guidance of the United States Supreme Court and other federal and state courts, as it did in *Searsy*, the Court concluded that, "[b]ased on these authorities and our reading of the statute's language, . . . three key principles must guide our construction and application of the term 'investment contract.'"[35] In accordance with these guiding principles, the Court re-clarified the term as it applies to the Texas Securities Act and held that "the entrepreneurial or managerial efforts that are relevant to this inquiry . . . include those that are made prior to the transaction as well as those that are made after."[36] Accordingly then, applying its restated definition to Life Partners' life settlement agreements, the Court held that, "based on the undisputed material facts," the agreements in question "are investment contracts, and thus securities, under the Texas Securities Act."[37]

A. Guiding Principles & the *Howey/Forman* Test

The Court begins its analysis by discussing the origins of the term "investment contract" and how it has been interpreted by the United States Supreme Court.[38] Relying on a number of state court constructions of the term, the Supreme Court, in *S.E.C. v. W.J. Howey Co.*,[39] "noted that state courts 'broadly construed' the term" and "disregarded 'form' over 'substance,'" emphasizing "the 'economic reality' of the transactions."[40] The Supreme Court thus concluded that "an investment contract for purposes of the [Federal] Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party."[41]

Clarifying the definition from *Howey*, the Supreme Court again, in *United Housing*

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[31] State v. Life Partners Holdings, Inc., 459 S.W.3d 619, 619 (Tex. App.—Austin 2014) (mem. op.), *aff'd sub nom.*, Life Partners, Inc. v. Arnold, 464 S.W.3d 660 (Tex. 2015)

[32] *Life Partners*, 464 S.W.3d at 663 (footnote omitted) (discussing the facts of *Life Partners Holdings*).

[33] *Id.*

[34] *See id.* at 666–67.

[35] *Id.* at 667.

[36] *Id.* at 681.

[37] *Id.* at 682.

[38] *Id.* at 666–70.

[39] 328 U.S. 293 (1946).

[40] *Life Partners*, 464 S.W.3d at 668 (quoting *Howey*, 328 U.S. at 298).

[41] *Howey*, 328 U.S. at 298–99.

Foundation, Inc. v. Forman,[42] "explained that Congress 'sought to define the term 'security' in sufficiently broad and general terms so as to include within that definition the many types of instruments that . . . fall within the ordinary concept of a security.'"[43] The Court reemphasized that "Congress intended the application of these statutes to turn on the economic realities underlying a transaction and not on the name" the parties had given it.[44] Slightly restating the *Howey* test, the Court clarified that "[t]he touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the *entrepreneurial or managerial efforts of others*."[45]

While the Texas Supreme Court's analysis and review of these Supreme Court decisions[46] is relevant for the purposes of reiterating the appropriate test under the Texas Securities Act, the Court further explained that "they also describe the proper *approach* to the term's construction."[47] Accordingly, the Court derived "from these cases three key principles to guide [its] application of the *Howey/Forman* test to any particular transaction":[48]

> First, we must "broadly construe[]" the term "investment contract" to maximize the protection the Act is intended to provide to the investing public. Second, we must focus on the "economic realities" of the transaction to determine whether it meets the test's requirements. And third, if the "economic realities" satisfy the requirements, we must conclude that the transaction is an "investment contract" regardless of the labels or terminology the parties used to describe it.[49]

"Following the lead of numerous other courts," the Court concluded that it "accept[s] and appl[ies] these guidelines when using the *Howey/Forman* test to determine whether a transaction constitutes an 'investment contract.'"[50]

B. "Profits from the Efforts of Others"

The Court then moved on to consider the element at issue in the case—that the investor is "led to expect profits 'solely from the efforts of the promoter or third party.'"[51] Looking to its guiding principles and again to the reasoning and decisions of other courts, the Court reviewed the test's proper application and transformation after *Howey*, "particularly with regard to (1) whether the profits must come 'solely' from the efforts of others, and (2) the kinds of 'efforts' of promoters and others on which the purchasers must rely."[52] In light of this review, the

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[42] 421 U.S. 837 (1975).

[43] *Life Partners*, 464 S.W.3d at 669 (quoting *Forman*, 421 U.S. at 847–48).

[44] *Forman*, 421 U.S. at 849.

[45] *Id.* at 852 (emphasis added).

[46] In addition to *Howey* and *Forman*, the Court also discussed the reasoning and principles applied in S.E.C v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943), Reeves v. Ernst & Young, 494 U.S. 56 (1990), and S.E.C. v. Edwards, 540 U.S. 389 (2004).

[47] *Life Partners*, 464 S.W.3d at 670.

[48] *Id.*

[49] *Id.* (alteration in original) (citations omitted).

[50] *Id.* at 670–71.

[51] *Id.* at 671.

[52] *Id.*

Court then further clarified and restated the "'efforts' aspect of the *Howey/Forman* test."[53]

First, regarding the amount or distribution of efforts involved in the enterprise (i.e., between the investor and the promoter or other third parties), the Court reiterated the approach it adopted in *Searsy*.[54] There, the Court concluded that the proper test "inquires whether the investor made any *significant* efforts," not whether they made *any* efforts at all.[55] Accordingly, "even if the purchaser's profits depend in part on the purchaser's own efforts," the *Life Partners* Court concluded as it did in *Searsy* that "a transaction will satisfy the 'efforts' element of the *Howey/Forman* test if the efforts of others 'are undeniably significant ones, those essential managerial efforts which affect the failure or success of the enterprise.'"[56]

Likewise, regarding the "kinds" of efforts that are "significant" in applying the *Howey*/*Forman* test, the Court again re-urged the approach it adopted in *Searsy*.[57] There, the Court adopted the Ninth Circuit's language from *Turner Enterprises*, where the Ninth Circuit held that "the 'efforts' that count 'are the undeniably significant ones, those *essential managerial efforts* which affect the failure or success of the enterprise.'"[58] In other words, the Court noted that the key consideration is whether "the holder is relying on the managerial skills of others to generate his profit."[59] Thus, "[b]y implication, if the holder is relying on his own entrepreneurial talents to generate his profit, his interest is not treated as a security."[60] The Court then discussed again the decisions and reasoning of several other courts and concluded,

> The cases thus indicate that, to constitute an investment contract under the "efforts" aspect of the *Howey/Forman* test, the transaction must be such that, in reality, the seller, or another party other than the purchaser, exercises the predominate managerial or entrepreneurial control on which the purchaser's anticipation of profits is based. Conversely, courts have recognized that control over merely "ministerial" or "clerical" functions does not constitute the kind of "significant efforts" that satisfy the *Howey/Forman* test.[61]

Furthermore, "[b]ecause the *Howey/Forman* test does not strictly require that the purchaser rely 'solely' on the efforts of others," the Court reiterated that "the distinction between 'managerial or entrepreneurial control' and 'perfunctory or ministerial duties'" must be applied "to the activities of both the purchasers and the sellers in any given transaction."[62]

C. Pre-purchase versus Post-purchase Efforts

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53 *Id.* at 674.

54 *Id.* at 672–73.

55 *Searsy*, 560 S.W.2d at 641 (emphasis added).

56 *Life Partners*, 464 S.W.3d at 673 (quoting *Searsy*, 560 S.W.2d at 641).

57 *Id.*

58 *Id.* (emphasis added) (quoting *Turner Enterprises*, 474 F.2d at 482).

59 *Id.* at 674 (quoting Siebel v. Scott, 725 F.2d 995, 999 (5th Cir. 1984)).

60 *Id.* (quoting *Siebel*, 725 F.2d at 999).

61 *Id.* at 674–75 (footnote omitted).

62 *Id.* at 675.

After re-analyzing the basic concepts of the *Howey*/*Forman* test and its application by other courts, the Court next turned to the central issue in the case—whether pre-purchase efforts are relevant in determining if a transaction constitutes an investment contract.[63] In general, the Court first noted that "[e]arly cases applying the *Howey/Forman* test generally focused on the efforts and control that the parties exercised *after* the transaction occurred."[64] However, the Court then discussed some cases that have addressed the issue more directly.

In particular, the Court focused on the D.C. Circuit's opinion in *S.E.C. v. Life Partners, Inc.*,[65] which addressed facts nearly identical to those in the present case and specifically dealt with "whether the efforts [Life Partners] exerted *before* the transaction were relevant to the *Howey/Forman* analysis."[66] In that case, a majority of the D.C. Circuit held that "prepurchase services cannot by themselves suffice to make the profits of an investment arise predominantly from the efforts of others."[67] However, the Court in *Life Partners* also focused heavily on the dissent from D.C. Circuit's decision.[68] Justice Wald's dissenting opinion rejected "the majority's conclusion that pre-purchase efforts 'should be categorically excluded,'" and instead, concluded that "'the *Howey* test can be met by pre-purchase managerial activities of a promoter when it is the success of these activities, either entirely or predominantly, that determines whether profits are eventually realized.'"[69]

Following the D.C. Circuit's decision, the Waco Court of Appeals also addressed the same issue, in *Griffitts v. Life Partners, Inc.*, and reached the same result as the D.C. Circuit's majority.[70] "The following year, however," the Court noted, "[T]he Eleventh Circuit Court of Appeals reached the opposite conclusion in *S.E.C. v. Mutual Benefits Corp.*"[71] There, the Eleventh Circuit expressly "deline[d] to adopt the test established by the [D.C. Circuit] *Life Partners* court," and it rejected the notion that *Howey* "require[s] such a clean distinction between a promoter's activities prior to his having use of an investor's money and his activities thereafter."[72] Accordingly, "[b]ecause the 'investors relied on both the pre- and post-purchase managerial activities of [the promoter] . . . ,' the court concluded that the promoter 'thus offered what amounts to a classic investment contract.'"[73] The Court next moved on to restate and confirm the Texas test.

D. The Texas Test, Clarified and Confirmed

Mentioning again that "many courts throughout the country have addressed the meaning

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[63] *Id.* at 676.

[64] *Id.*

[65] 87 F.3d 536 (D.C. Cir. 1996) [hereinafter *D.C. Cir. Life Partners*].

[66] *Life Partners*, 464 S.W.3d at 676 (citing *D.C. Cir. Life Partners*, 87 F.3d 536).

[67] *D.C. Cir. Life Partners*, 87 F.3d at 547.

[68] *Life Partners*, 464 S.W.3d at 676–78 (discussing *D.C. Cir. Life Partners*, 87 F.3d at 549–56 (Wald, J., dissenting)).

[69] *Id.* at 677–78 (quoting *D.C. Cir. Life Partners*, 87 F.3d at 551 (Wald, J., dissenting)).

[70] No. 10-01-00271-CV, 2004 WL 1178418 (Tex. App.—Waco May 26, 2004, no pet.) (mem. op.).

[71] *Life Partners*, 464 S.W.3d at 679 (citing S.E.C. v. Mut. Benefits Corp., 408 F.3d 737 (11th Cir. 2005)).

[72] *Id.* (quoting *Mut. Benefits Corp.*, 408 F.3d at 743).

[73] *Id.* at 680 (quoting *Mut. Benefits Corp.*, 408 F.3d at 744).

of 'investment contract,'" the Court went on to briefly discuss the development of the *Howey*/*Forman* test in Texas.[74] The Court concluded,

> Having reviewed both the statute's language and the extensive authorities from Texas and throughout the country, we now confirm and clarify, *first*, that the Texas Securities Act's definition of "securities" must be construed broadly to maximize the protection it provides to investors, while focusing on the economic realities of the transaction regardless of any labels or terminology the parties may have used.[75]

"*Second*, in light of these guiding principles and consistent with the uniform constructions of the precedents [it] discussed,"[76] the Court restated its definition of "investment contract":

> [W]e confirm and clarify that an "investment contract" for purposes of the Texas Securities Act means a contract, transaction, or scheme through which a person pays money to participate in a common venture or enterprise with the expectation of receiving profits, under circumstances in which the failure or success of the enterprise, and thus, the person's realization of the expected profits, is at least predominately due to the entrepreneurial or managerial, rather than merely ministerial or clerical, efforts of others.[77]

In other words, for a transaction to qualify as an investment contract it must involve (1) "the payment of money," (2) "a common enterprise," (3) "the expectation of profits," and (4) "dependence *predominately* on the entrepreneurial or managerial efforts of others to achieve the anticipated profits."[78]

Third, the Court held that "the entrepreneurial or managerial efforts that are relevant to this inquiry, whether those of the purchasers or of others, include those that are made prior to the transaction as well as those that are made after."[79] Relying heavily on Judge Wald's dissent, in particular, the Court made clear that Texas's version of the *Howey*/*Forman* test "can be met by pre-purchase managerial activities."[80] The Court explained, "[T]he key question is not when the efforts of others take place, but whether they are entrepreneurial or managerial efforts that affect the failure or success of the enterprise."[81]

E. The Law Applied to Life Partners' Life Settlement Agreements

Applying its restated definition to Life Partners' life settlement agreements, the Court held that, "based on the undisputed material facts[,] . . . they are investment contacts, and thus

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74 *Id.*

75 *Id.* at 681.

76 *Id.*

77 *Id.*

78 *Id.* at 682.

79 *Id.* at 681.

80 *Id.* at 682 (quoting *D.C. Cir. Life Partners*, 87 F.3d at 551 (Wald, J., dissenting)).

81 *Id.*

securities, under the Texas Securities Act."[82] The Court explained that "Life Partners' pre-purchase efforts are 'undeniably essential to the overall success of the investment.'"[83] In particular, Life Partners' pre-purchase efforts require it "to accurately evaluate the insured's life expectancy and to set the correct purchase price (discount) to yield a profit based on the insured's life expectancy, future premiums, and end-value of the policy's benefits."[84] In other words, the investors' expectations of profits are almost entirely reliant on Life Partner's pre-purchase predictions and decisions, and as such, they clearly meet the required standard. Regarding post-purchase efforts, the Court considered the fact that Life Partners "holds legal title to the policy, monitors the insured and the policy premium payments, and collects and distributes the necessary funds."[85] Thus, the Court concluded that, because "Life Partners exercises complete control and discretion over the investment and the investment's success," their "post-purchase efforts are managerial, not ministerial."[86]

Accordingly, the Court held that the life settlement agreements at issue "are investment contracts, and thus securities, under the Texas Securities Act."[87] Moreover, because the Court concluded its "decision merely interprets and applies a very old law, consistent with the manner in which other courts have interpreted and applied it for decades," the Court declined to limit its holding to only prospective application, as Life Partners had requested.[88] Finally, the Court agreed with the Austin Court of Appeals and remanded the issues regarding the "relief defendants" for further proceedings in the trial court.[89]

V. Potential Impact[90]

The Texas Supreme Court's unanimous decision in *Life Partners* solidifies and reinforces some of the most important protections for investing consumers in Texas.[91] Confirming that the Texas Securities Act "must be construed broadly to maximize the protection it provides to investors," the decision re-emphasized the United States Supreme Court's "flexible approach" and realigned Texas with the overwhelming majority of States in their interpretations of the term "investment contract."[92] Consequently, life settlement agreements like those offered by

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[82] *Id.*

[83] *Id.* (quoting *D.C. Cir. Life Partners*, 87 F.3d at 547).

[84] *Id.*

[85] *Id.* at 683.

[86] *Id.*

[87] *Id.* at 684.

[88] *Id.* at 685.

[89] *Id.* at 686 ("The State sued these Petitioners as 'relief defendants,' seeking equitable relief 'on the belief that they might hold property or assets belonging to Life Partners.'").

[90] The author would like to thank Michael J. Durrschmidt of Hirsch and Westheimer P.C. for his valuable input and suggestions regarding this section of the article.

[91] Jess Davis, *Texas Supreme Court Says Life Partners Sold Securities*, Law360 (May 8, 2015, 2:54 PM), http://www.law360.com/articles/653461/texas-supreme-court-says-life-partners-sold-securities (quoting Keith Langston of Langston Law Firm, the attorney for the investors) ("It's a good victory for Texas consumers as a whole. It provides them with the requisite security that anybody who wants to do this in the future now is required to register these products with the Texas State Securities Board, and future investors will now have access to all the information necessary to make an informed decision before they invest.").

[92] *Life Partners*, 464 S.W.3d at 681; *see also* SEC Report, *supra* note 18, at 36 ("A majority of states include

Life Partners are now subject to the registration and disclosure requirements of the Texas Securities Act.[93] Again, securities regulations "embody the belief that information is the most important from of investor protection."[94] The Court's unanimous decision now extends that protection to investors considering the purchase of these life settlement agreements, which have allegedly involved a significant amount of fraud over the years.[95]

Life Partners, on the other hand, argued that "the consideration of pre-purchase efforts will transform every traditional land acquisition or purchase for use or consumption into an 'investment contract,'" but this is unlikely.[96] As the Court pointed out, every disputed transaction still must meet the Court's definition.[97] Also, as mentioned earlier, interpreting the term "investment contract" to include life settlement agreements is by no means a new idea, and there is no indication that this minor extension of the term (in line with the statutes purpose and a majority of other jurisdictions) has had such an effect elsewhere. Shifting focus from the time of the efforts to the kinds of efforts at issue does not, by any means, equate to removing the efforts analysis all together. The bottom line is that the law regarding life settlement agreements has been moving in this direction for some time, and at least in the Court's opinion, the official shift in Texas will have little impact on other similar transactions because they still must meet the Court's now further clarified definition.

Additionally, one commentator mentioned that one of the biggest impacts of the Court's decision is the fact that the Court declined to give its ruling only prospective application.[98] Due to the relevant statutes of limitations,[99] Life Partners and other similar companies are now

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life settlements in their statutory definition of 'security,' either directly in that definition, or as part of the definition of 'investment contract.'"); George Lee Flint, Jr., *Securities Regulation*, SMU L. Rev. 102 (forthcoming), http://smulawreview.law.smu.edu/getattachment/Journals/TX-Survey/2015-Texas-Survey/Securities-Regulation.pdf ("Texas courts have joined the rest of the nation in concluding that interests in life settlements constitute 'investment contracts' and therefore securities under the TSA.").

[93] *See* Tex. Rev. Civ. Stat. Ann. art. 581-7.A(1), 581–33 (West 2012).

[94] S.E.C. v. Life Partners, Inc., 87 F.3d 536, 550 (D.C. Cir. 1996) (Wald, J., dissenting).

[95] Brief of Amicus Curiae: North American Securities Administrators, Inc. at 14, Life Partners, Inc. v. Arnold, 464 S.W.3d 660 (Tex. 2015) (No. 14-0122), 2014 WL 7208665 ("Life settlements are rife with fraud and the potential for investor abuse. Over the last fifteen years, there have been widespread problems in the sale of Life Settlement Contracts, and as a result, thousands of investors have lost significant amounts of money. The patterns of investor abuse in the sale of these products are well documented.").

[96] *Life Partners*, 464 S.W.3d at 681–82.

[97] *Id.* at 682 ("[W]e believe the various aspects of the definition we have provided are sufficient to ensure that the transaction in question is the type of 'investment contract' the Act aims to address. The transaction must involve the payment of money, a common enterprise, the expectation of profits and dependence *predominantly* on the entrepreneurial or managerial efforts of others to achieve the anticipated profits . . . .").

[98] *Life Partners, et al. v. Arnold et al.; Texas Supreme Court confirms fractionalized life settlement interests sold to Texas investors are Investment Contracts*, Locke Lord (May 27, 2015) [hereinafter Locke Lord], http://www.lockelord.com/newsandevents/publications/2015/05/life-partners-et-al-v-arnold-et-al-texas-supreme-court-confirms-fractionalized-life-settlement-interests-sold-to-texas-investors-are-investment-contracts ("Perhaps the most intriguing (and somewhat unexpected) aspect of the Texas Supreme Court ruling was that it should be afforded retroactive application.").

[99] See Tex. Rev. Civ. Stat. Ann. art. 581-33.H(1), (2) (West 2012); Flint, *supra* note 92, at 107 (A claim based on the sale of unregistered securities or other related violations "carries a three year statute of limitations, which begins running at the time of the sale. A 'sale by misstatement' claim carries limitations of five years from the sale, and three years from the time the buyer should have discovered the misstatement.").

potentially subject to a significant amount of liability for transactions completed up to three to five years ago.[100] Undoubtedly, this potential liability and a number of other similar concerns played a large part in Life Partners' decision to file for bankruptcy in January.[101]

The proceedings in the bankruptcy court have raised some other very interesting issues, such as what interest the investors in these life settlement agreements actually own.[102] Technically, the investors "do not have legal title to the insurance policy."[103] Instead, "[w]hen Life Partners purchases a policy, it becomes the legal owner [and] appoints a trustee to serve as the beneficiary."[104] In fact, the insurance policy is typically not even purchased until after the investors have paid for the life settlement agreements.[105] Thus, the transfer of the investors' interest in the life settlement normally precedes the transfer of Life Partners' interest in the insurance policy. Furthermore, even assuming the investors do have something more than a mere contract right, they still only own a fractionalized interest in any one life insurance policy.[106]

Consequently, the investors' position in the bankruptcy is tenuous to say the least, and the Trustee's final determination could have far reaching implications on similar transactions in the future, possibly even ones in other states.[107] Most likely, this will again require investors to be more conscious of the types of transactions they are entering into. At least now these investors have access to the necessary information, and this is the core principle of the securities regulations.

VI. Conclusion

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[100] Locke Lord, *supra* note 98 ("[The retroactive application] issue is very significant because, among other things, there is a three year automatic strict liability rescission right for purchasers of a security that should have been, but were not, registered under the Texas Securities Act.").

[101] *See* Davis, *supra* note 91 ("Life Partners Holdings Inc. filed for Chapter 11 protection in January, in a bid to buy time while it appeals a $47 million judgment won by the U.S. Securities and Exchange Commission against the holding company and Life Partners executives Brian Pardo and Scott Peden, who resigned in February. The bankruptcy judge in March appointed a trustee, and in April authorized the trustee to file bankruptcy petitions on behalf of LPHI subsidiaries, including Life Partners Inc. and LPI Financial Services Inc.").

[102] Locke Lord, *supra* note 98 ("The Trustee in the bankruptcy proceeding has seized upon the Texas Supreme Court case to take some very significant positions with respect to the life settlement investors which, using his terminology, hold "Contract Positions" with respect to the death benefits payable to the escrow agents in connection with approximately 3,600 life insurance policies with an aggregate face value in excess of $2.4 billion owned of record by Life Partners.").

[103] *Life Partners*, 464 S.W.3d at 666.

[104] *Id.* at 664.

[105] *Id.* ("Life Partners uses the purchasers' funds to (1) pay the insured for the policy, (2) create an escrow account from which to pay the policy's future premiums as they come due, (3) pay fees to escrow agents and to any brokers who helped sell the interests to the purchasers, and (4) pay Life Partners an administration or brokerage fee.").

[106] Locke Lord, *supra* note 98 ("This case impacts the sale of fractionalized interests only . . . .").

[107] *Id.* ("Until the Trustee can sort through the complexities of the bankruptcy proceeding and potential claims of creditors/contract position holders, particularly in light of the Texas Supreme Court decision, he has suspended all payments of death benefit proceeds to contract position holders, advised them that they remain obligated to fund premium calls and servicing expenses for the life insurance policies with respect to which they hold contract positions and has frozen the sale and transfer of any of the contract positions on the grounds that such transfers might be in violation of applicable state security laws (presumably not limited to Texas.").

Accordingly, the Texas Supreme Court's decision in Life Partners effectively finalizes a decisive shift in Texas securities law in favor of the investing public. While there may be other related effects of the Court's opinion, this is biggest and most important—life settlement agreements like the ones offered by Life Partners must be offered and sold in accordance with Texas securities regulations. While the issue is still largely undecided at the federal level, the fact that life settlement agreements are investment contracts, and thus securities, under the Texas Securities Act is now decided, and the relevance of pre-purchase efforts is definitively established.