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ENTITY ACQUISITIONS UNDER THE TEXAS BUSINESS ORGANIZATIONS CODE, INCLUDING THE 2015 AMENDMENTS

Richard A. Tulli & Daryl B. Robertson

CROWDFUNDING AND THE PUBLIC/PRIVATE DIVIDE IN U.S. SECURITIES REGULATION

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CONTENTS:

ENTITY ACQUISITIONS UNDER THE TEXAS BUSINESS ORGANIZATIONS CODE, INCLUDING THE 2015 AMENDMENTS <i>Richard A. Tulli & Daryl B. Robertson</i>	89
CROWDFUNDING AND THE PUBLIC/PRIVATE DIVIDE IN U.S. SECURITIES REGULATION <i>Joan MacLeod Heminway</i>	131
SOME KEY THINGS U.S. ENTREPRENEURS NEED TO KNOW ABOUT THE LAW AND LAWYERS <i>Lawrence J. Trautman, Tony Luppino & Malika Simmons</i>	155
RECENT BUSINESS DEVELOPMENTS	
<i>Oral Agreement Exception to Statute of Frauds</i>	203
<i>Privilege in Reports Re Possible Criminal Activity</i>	209
<i>A Court's Authority to Determine Arbitrability</i>	215
<i>Scope and Effect of Copyright Act's Preemption of State Law</i>	221
<i>Forum Selection Bylaw</i>	227

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**ENTITY ACQUISITIONS
UNDER THE TEXAS BUSINESS
ORGANIZATIONS CODE, INCLUDING THE 2015 AMENDMENTS**

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I.	INTRODUCTION TO CODE.....	90
II.	GENERAL STRUCTURE OF CODE	90
III.	TITLE 1	93
IV.	NEW VOCABULARY OF THE CODE	93
V.	KEY DEFINITIONS FOR FUNDAMENTAL BUSINESS TRANSACTIONS.....	97
VI.	SUMMARY OF CHAPTER 10 GOVERNING FUNDAMENTAL BUSINESS TRANSACTIONS.....	100
VII.	TITLE 2 – CORPORATIONS	103
	A. For-Profit Corporations	103
	B. Nonprofit Corporations	108
	C. Special-Purpose Corporations	109
VIII.	TITLE 3 – LIMITED LIABILITY COMPANIES.....	109
IX.	TITLE 4 – PARTNERSHIPS.....	110
	A. General	110
	B. General Partnerships	110
	C. Limited Partnerships	111
	D. Both General and Limited Partnerships	111
X.	TITLE 5 – REAL ESTATE INVESTMENT TRUSTS	112
XI.	TITLE 6 – ASSOCIATIONS	112
	A. General Provisions	112
	B. Cooperative Associations.....	112
	C. Unincorporated Nonprofit Associations.....	113
XII.	TITLE 7 – PROFESSIONAL ENTITIES.....	113
	A. General Provisions	113
	B. Professional Associations.....	113
	C. Professional Corporations	113
	D. Professional Limited Liability Companies.....	114
XIII.	FUNDAMENTAL BUSINESS TRANSACTIONS	114
	A. Mergers.....	114
	B. Conversions.....	118
	C. Interest Exchanges.....	121
	D. Sales of Assets.....	122
	E. Franchise Taxes.....	122
	F. Approval Procedures	123
	G. Abandonment	123
	H. Dissenters’ Rights	123

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XIV. MISCELLANEOUS PROVISIONS IN OTHER CHAPTERS IN TITLE 1..	127
A. Chapter 3 Formation and Governance	127
B. Chapter 4 Filings	127
C. Chapter 5 Registered Agents.....	127
D. Chapter 6 Meetings and Voting	128
E. Chapter 8 Indemnification and Insurance	128
F. Chapter 9 Foreign Entities.....	128

I. INTRODUCTION TO CODE

The Texas Business Organizations Code (the TBOC or the Code) is a substantive codification of the prior Texas statutes governing non-profit and for-profit private-sector entities, which, for the most part, were repealed effective as of January 1, 2010. These statutes consisted of the Texas Business Corporation Act (TBCA), Texas Miscellaneous Corporation Laws Act (TMCLA), Texas Limited Liability Company Act (TLLCA), Texas Revised Limited Partnership Act (TRLPA), Texas Revised Partnership Act (TRPA), Texas Non-Profit Corporation Act (TNPCA), Texas Real Estate Investment Trust Act (TREITA), Texas Uniform Unincorporated Nonprofit Associations Act (TUUNAA), Texas Professional Corporation Act (TPCA), Texas Professional Associations Act (TPAA), Cooperative Associations Act (CAA) and other existing provisions of Texas statutes governing private entities.

The Code was a joint project of the Business Law Section of the State Bar of Texas and the Office of the Texas Secretary of State. The Texas Legislative Council provided drafting and editing assistance. The Code has been under development since 1995, when the Business Law Section first formed a committee to study codification of the foregoing statutes. This committee evolved into a drafting committee (the Committee) that included representatives of the Secretary of State's Office, solo practitioners, law firm lawyers and prominent law professors from several Texas law schools.

The Committee's continuing work to improve the Code has resulted in amendments to the Code effective September 1, 2015 that, as relevant, are briefly described below in this article.

II. GENERAL STRUCTURE OF CODE

The Code consists of thirty (30) Chapters divided into eight (8) Titles. The Titles of the Code are set forth below:

Title 1 General Provisions

Title 2 Corporations

Title 3 Limited Liability Companies

Title 4 Partnerships

2016] ENTITY ACQUISITIONS UNDER TBOC 91

Title 5 Real Estate Investment Trusts

Title 6 Associations

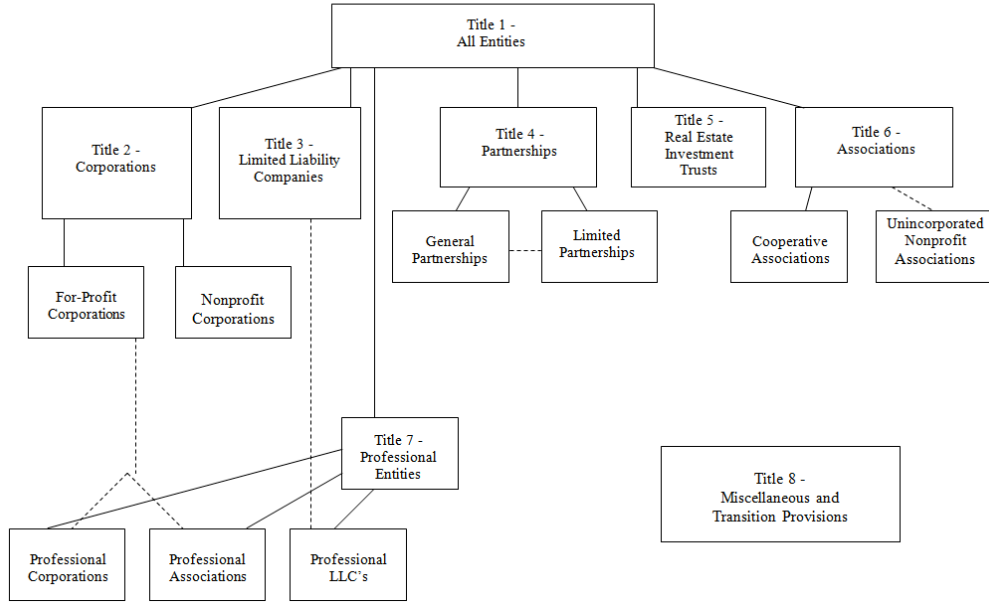
Title 7 Professional Entities

Title 8 Miscellaneous and Transition Provisions

This article focuses on those provisions in the Code that apply to mergers, conversions, interest exchanges and sales of assets by domestic entities. The bulk of those kinds of provisions are found in Title 1 General Provisions. Some provisions can also be found in each of Titles 2 through 7, but those provisions generally relate only to the requirements for domestic entities to approve one of these kinds of transactions.

A structure chart that illustrates the organization of the Titles of the Code can be found on the following page.

BUSINESS ORGANIZATIONS CODE STRUCTURE



2016]

ENTITY ACQUISITIONS UNDER TBOC

93

III. TITLE 1

Title 1 contains the common provisions that generally apply to most types of entities. The Chapters of “Title General Provisions” are set forth below:

Chapter 1 Definitions and Other Provisions

Chapter 2 Purposes and Powers of Domestic Entity

Chapter 3 Formation and Governance

Chapter 4 Filings

Chapter 5 Names of Entities; Registered Agents and Registered Offices

Chapter 6 Meetings and Voting

Chapter 7 Liability

Chapter 8 Indemnification and Insurance

Chapter 9 Foreign Entities

Chapter 10 Mergers, Exchanges, Conversions and Sales of Assets

Chapter 11 Winding up and Termination of Domestic Entity

Chapter 12 Administrative Powers

The primary provisions in the Code that apply to mergers, conversions, interest exchanges and sales of assets by domestic entities can be found in Chapter 1 Definitions and Other Provisions and in Chapter 10 Mergers, Exchanges, Conversions and Sales of Assets. Other less directly applicable provisions can be found in Chapter 3 Formation and Governance, Chapter 4 Filings and Chapter 6 Meetings and Voting.

IV. NEW VOCABULARY OF THE CODE

The key to understanding most of the Title 1 provisions is Section 1.002 of the Code, which contains the definitions for many of the terms used in the Code. This section introduces new terminology not found in the prior statutes primarily for the purpose of the provisions of Title 1. Because Title 1 applies to most entities, common terms used for all entities had to be formulated.

The following discussion summarizes some of the new definitions introduced by the Code:

1. “*Organization*” — defined by a long list of different types of entities or organizations, regardless of whether for-profit, non-profit, domestic or foreign. The term is

essentially intended to refer in the broadest sense to any kind of entity or organization regardless of jurisdiction of formation or purpose.²

2. “*Non-code organization*” — an organization other than a domestic entity.³ The term essentially includes either a foreign entity or an organization formed under a Texas law other than the Code, such as banks and insurance companies.

3. “*Entity*” — either a domestic entity or a foreign entity.⁴

(A) “*Domestic entity*” — an organization formed under or the internal affairs of which are governed by the Code.⁵

(i) “*Filing entity*” — a domestic corporation, limited partnership, limited liability company, professional association, cooperative or real estate investment trust.⁶ These domestic entities require a filing with the Secretary of State or a county clerk’s office as a condition to formation. The term does not include a general partnership that is a limited liability partnership notwithstanding the requirement to register annually with the Secretary of State.

(ii) “*Nonfiling entity*” — a domestic entity other than a filing entity.⁷ This type of entity does not require a formal filing as a condition to formation. Included in the term are general partnerships⁸ and non-profit associations.⁹

(B) “*Foreign entity*” — an organization formed under and whose internal affairs are governed by the laws of a jurisdiction other than Texas.¹⁰

(i) “*Foreign filing entity*” — a foreign entity that registers or is required to register as a foreign entity under Chapter 9 of the Code, except for a foreign limited liability partnership.¹¹

² TEX. BUS. ORGS. CODE ANN. § 1.002(62) (West 2015).

³ *Id.* at (56).

⁴ *Id.* at (21).

⁵ *Id.* at (18).

⁶ *Id.* at (22).

⁷ *Id.* at (57).

⁸ The reference to “general partnerships,” by virtue of the definition of that term, includes domestic limited liability partnerships even though they are required to register by filing with the Secretary of State. *See id.* § 152.802(a). Subchapter J of the Code was amended effective January 1, 2016 by Senate Bill 859, passed by the 2015 Texas Legislature, to require domestic limited liability partnerships to file annual reports with the Texas Secretary of State instead of requiring them to file annual renewals of registration.

⁹ *Id.* § 1.002(57).

¹⁰ *Id.* at (28).

¹¹ *Id.* at (29). The specific exclusion of foreign limited liability partnerships from the definition of the term “foreign filing entity” prevents the anomalous result of treating foreign limited liability partnerships as filing entities while treating domestic limited liability partnerships as non-filing entities.

(ii) “*Foreign nonfiling entity*” — a foreign entity that is not a foreign filing entity.¹²

(C) “*Nonprofit entity*” — an entity that is organized solely for one or more of the non-profit or charitable purposes specified in Section 2.002 of the Code and includes a non-profit corporation and non-profit association.¹³

(D) “*For-profit entity*” — an entity other than a non-profit entity.¹⁴

(E) “*Professional entity*” — Chapter 1 incorporates this definition from Chapter 301.¹⁵ It means a “*professional association*,” “*professional corporation*” or “*professional limited liability company*.”¹⁶ These terms are defined in Chapter 301 to mean an association, corporation, or limited liability company, respectively, formed for the purpose of providing a professional service and governed as professional entity under Title 7.¹⁷ The term “professional entity” does not include a general partnership or limited liability partnership providing professional services.

Each entity has either “*owners*”¹⁸ or “*members*”¹⁹ which in turn correspond to “*ownership interests*”²⁰ or “*membership interests*,”²¹ respectively, in the entity. For-profit corporations, real estate investment trusts and partnerships have “*owners*,” while non-profit corporations and unincorporated non-profit associations have “*members*.” Limited liability companies, cooperative associations and professional associations have both “*members*” and “*owners*,” and these terms are used interchangeably for these kinds of entities.

A domestic “*filing entity*” is formed by filing a “*certificate of formation*,”²² which replaces the articles of incorporation, articles of organization, certificate of limited partnership or similar document as used in the prior statutes. The term “*organizer*” is used in Chapter 3 in

¹² *Id.* at (31).

¹³ *Id.* at (60).

¹⁴ *Id.* at (26). Section 3.007(d) of the Code provides that a for-profit corporation may include in its certificate of formation one or more social purposes in addition to the purpose or purposes required to be stated in its certificate of formation. *Id.* § 3.007(d). The term “social purposes” is defined in Section 1.002(82-a). *Id.* § 1.002(82-a).

¹⁵ § 1.002(73).

¹⁶ *Id.* § 301.003(4).

¹⁷ *Id.* at (2), (3), (6). The professional service to be provided by a professional corporation must also be one that by law a corporation governed by Title 2 is prohibited from rendering. *Id.* at (3). The professional service of a professional association is limited to that rendered by a doctor of medicine, doctor of osteopathy, doctor of podiatry, dentist, chiropractor, optometrist, therapeutic optometrist, veterinarian, or licensed mental health professional. *Id.* at (2). The term “licensed mental health professional” is defined in Chapter 301 to mean a non-physician who is licensed to practice psychology or psychiatric nursing or to provide professional therapy or counseling services. *Id.* at (1).

¹⁸ *Id.* § 1.002(63).

¹⁹ *Id.* at (53).

²⁰ *Id.* at (64). The term means an owner’s interest in an entity, including the owner’s share of profits and losses and the right to receive distributions, but not the owner’s right to participate in management.

²¹ *Id.* at (54). The term means the member’s interest in an entity. For a limited liability company, it includes a member’s share in profits and losses and right to receive distributions, but not the right to participate in management.

²² *Id.* at (6).

place of “*incorporator*.” The organizer must sign the certificate of formation.²³ The certificate of formation and the other documents or agreements adopted by the entity to govern the formation or internal affairs of the entity constitute the “*governing documents*” of the domestic entity. Similarly, for a foreign entity, the instruments, documents and agreements that govern its formation or internal affairs constitute its “*governing documents*.”²⁴

A “*filing instrument*” is a document, instrument or statement that is required or authorized to be filed by or for an entity under the Code with the “*filing officer*.”²⁵

The person or group of persons who are entitled to manage and direct the affairs of an entity under the Code and the governing documents of the entity is referred to as the “*governing authority*.”²⁶ This term refers to:

- (a) the board of directors of a corporation or other persons authorized to perform the functions of the board of directors of a corporation,
- (b) the trust managers of a real estate investment trust,
- (c) the general partners of a partnership,
- (d) the managers of a limited liability company that is managed by managers,
- (e) the members of a limited liability company that is managed by its members,
or
- (f) the board of directors of a cooperative association.

A “*governing person*” is a person who serves on the governing authority of an entity.²⁷ A “*managerial official*” is:

- (a) an officer, or
- (b) a governing person.²⁸

The term “*officer*” is defined in a somewhat circular fashion to be an individual elected, appointed or designated as an officer of an entity by the governing authority or under the

²³ *Id.* § 3.004.

²⁴ *Id.* § 1.002(36).

²⁵ *Id.* at (23). The “*filing officer*” is the Texas Secretary of State for all entities other than domestic real estate investment trusts, for which filings must be made with the county clerk of the county in which the tenant’s principal office is located in Texas. *Id.* at (24).

²⁶ *Id.* at (35). The term “*governing authority*” does not include an officer who is acting in the capacity of an officer. *Id.*

²⁷ *Id.* at (37).

²⁸ *Id.* at (52).

governing documents.²⁹

The Code also introduces terms to facilitate electronic filing. The Code defines “*signature*” to mean any symbol executed or adopted by a person with present intention to authenticate a writing and includes a digital signature, electronic signature or a facsimile of such.³⁰ The terms “*writing*” or “*written*” are expanded to encompass textual information stored in an electronic or other medium that is retrievable in a perceivable form, and includes electronic data, “*electronic transmissions*” and reproductions of writings. These terms do not include sound or video recordings of speech.³¹ The term “*electronic transmission*” means a form of communication (other than the physical transmission of paper) that:

- (a) creates a record that may be retained, retrieved and reviewed by the recipient; and
- (b) may be directly reproduced in paper form by the recipient through an automated process.³²

V. KEY DEFINITIONS FOR FUNDAMENTAL BUSINESS TRANSACTIONS

The term “*fundamental business transaction*” means a merger, interest exchange, conversion, or sale of all or substantially all of an entity’s assets.³³ The term “*interest exchange*” is similar to the term “*share exchange*” as was used in the TBCA, but applies to exchanges of membership or ownership interests in all domestic entities.³⁴

“*Certificate of merger*,” “*certificate of exchange*,” and “*certificate of conversion*” are used in Chapter 10 to replace articles of merger, articles of exchange and articles of conversion, as used in the prior statutes.³⁵

The new term “*fundamental action*” is used in Chapters 21, 22 and 200 for for-profit corporations, non-profit corporations and real estate investment trusts, respectively, to refer collectively to amendments to the certificate of formation, voluntary decisions to wind up or to revoke a decision to wind up and other actions with respect to reinstatement of terminated domestic corporations and real estate investment trusts.³⁶ However, as used in Chapter 22 for non-profit corporations, the term also includes the types of transactions within the definition of “*fundamental business transaction*.”³⁷ This new defined term allows these chapters of the Code to pull together in one section the provisions specifying the vote required for approval by

²⁹ *Id.* at (61).

³⁰ *Id.* at (82).

³¹ *Id.* at (89).

³² *Id.* at (20-a).

³³ *Id.* at (32).

³⁴ *Id.* at (41).

³⁵ *Id.* §§ 10.151, 10.154.

³⁶ *Id.* §§ 21.364, 22.164, 200.261.

³⁷ *Id.* § 22.164.

the owners or members of the domestic entity to approve the fundamental action.

The term “*jurisdiction of formation*” is also new and refers to the state of Texas for domestic filing entities and, for a foreign entity for which a certificate of formation or similar organizational instrument is filed in connection with its formation, the jurisdiction in which the foreign entity’s certificate of formation (or similar organizational document) is filed. In the case of a domestic nonfiling entity or a foreign entity for which a certificate of formation or similar organizational instrument is not filed in connection with its formation, “*jurisdiction of formation*” means the jurisdiction chosen in the entity’s governing documents to govern its internal affairs if the jurisdiction bears a reasonable relation to the owners or members or to the entity’s business and affairs under contract law principles, or otherwise the jurisdiction in which the entity has its chief executive office.³⁸

The Code carries over other key definitions from the source statutes relating to fundamental business transactions, with some revisions to adopt the new terminology of the Code. The term “*merger*” means a combination of one or more domestic entities with one or more domestic entities or non-code organizations resulting in: (i) one or more surviving domestic entities or non-code organizations; (ii) the creation of one or more new domestic entities or non-code organizations; or (iii) one or more surviving domestic entities or non-code organizations and the creation of one or more new domestic entities or non-code organizations. In addition, the term can also mean the division of a domestic entity into two or more new domestic entities or other organizations or into a surviving domestic entity and one or more new domestic or foreign entities or non-code organizations.³⁹ This latter type of merger is generally referred to as a “*divisive merger*” by practitioners and is unique to Texas law as compared to the merger laws in most other states, including Delaware.

The term “*conversion*” is defined to mean: (A) the continuance of a domestic entity as a non-code organization of any type; (B) the continuance of a non-code organization as a domestic entity of any type; or (C) the continuance of a domestic entity of one type as a domestic entity of another type.⁴⁰ The definition of “*conversion*” also has language acknowledging that a conversion transaction may be known by another name (i.e., domestication, continuance or transfer transaction) in a jurisdiction outside of Texas.⁴¹

The term “*converted entity*” means an entity resulting from a conversion. The term “*converting entity*” means an entity as the entity existed before the entity’s conversion.⁴² A “*non-United States entity*” is defined as a foreign entity formed under, and the internal affairs of which are governed by, the laws of a “*non-United States jurisdiction*,” which in turn is defined as any foreign country or other foreign jurisdiction other than the United States, the District of Columbia, or any other possession or territory of the United States.⁴³

³⁸ *Id.* § 1.002(43).

³⁹ *Id.* at (55).

⁴⁰ *Id.* at (10).

⁴¹ *Id.*

⁴² *Id.* at (11) and (12).

⁴³ *Id.* at (56a) and (56b).

The term “*interest exchange*” is defined to mean the acquisition of an ownership or membership interest in a domestic entity in accordance with Chapter 10, other than by means of a merger or conversion.⁴⁴

The phrase “*party to a merger*” means a domestic entity or a non-code organization that under a plan of merger is divided or combined by a merger. The term does not include a domestic entity or a non-code organization that is not to be divided or combined into or with one or more domestic entities or non-code organizations, regardless of whether ownership interests of the entity are to be issued under the plan of merger.⁴⁵

Because the special voting requirements for the sale of all or substantially all of the assets of a domestic entity are only applicable to certain types of domestic entities, the definition of the phrase “*sale of all or substantially all of the assets*” is contained in the separate titles governing those entities.⁴⁶ The most detailed definitions of that phrase are located in the chapters governing for-profit corporations and real estate investment trusts.⁴⁷ Thus, for example, that phrase, as defined in Chapter 21 governing for-profit corporations, means the sale, lease, exchange or other disposition, other than a pledge, mortgage, deed of trust or trust indenture unless otherwise provided by the certificate of formation, of all or substantially all of the property and assets of a domestic corporation that is not made in the usual and regular course of the corporation’s business without regard to whether the disposition is made with the goodwill of the business.⁴⁸ The phrase does not include a transaction that results in the corporation directly or indirectly continuing to engage in one or more businesses or applying a portion of the consideration received in connection with the transaction to the conduct of a business that the corporation engaged in after the transaction.⁴⁹

Not all domestic entities provide to its owners the rights of dissent and appraisal in connection with a fundamental business transaction.⁵⁰ A domestic entity that provides to its owners such rights under the Code or the governing documents of the entity is referred to as a “*domestic entity subject to dissenters’ rights*.”⁵¹ Those entities that provide rights of dissent and appraisal are identified in Subchapter H, Chapter 10 and include for—profit corporations, professional corporations, professional associations and real estate investment trusts.⁵² Domestic limited liability companies and limited partnerships may elect to provide their owners such rights.⁵³

⁴⁴ *Id.* at (41).

⁴⁵ *Id.* at (69).

⁴⁶ *Id.* §§ 21.451(2), 22.252(h), 200.401(2).

⁴⁷ *Id.* §§ 21.451(2), 200.401(2).

⁴⁸ *Id.* § 21.451(2).

⁴⁹ *Id.* Because of this definition, shareholder approval may not be required regarding a sale of assets by a domestic for-profit corporation when it would be required for a similar sale by a foreign (e.g., Delaware) corporation under its governing law.

⁵⁰ *Id.* § 10.351(b).

⁵¹ *Id.* § 1.002(19).

⁵² *Id.* § 10.351(b).

⁵³ *Id.*

The terms “*plan of merger*,” “*plan of exchange*,” and “*plan of conversion*,” which are used extensively in Chapter 10 and elsewhere in the Code, simply mean a document that conforms with the requirements applicable to the type of plan in particular sections of Chapter 10, without specifying any particular format.⁵⁴ Amendments to Chapter 10 in 2015 clarified that a plan of merger, a plan of exchange and a plan of conversion need not be signed, but must only be in writing and adopted or approved as required by the Code.⁵⁵

VI. SUMMARY OF CHAPTER 10 GOVERNING FUNDAMENTAL BUSINESS TRANSACTIONS

Chapter 10 has nine subchapters and is the longest Chapter in Title 1. Chapter 10 relates to mergers, interest exchanges, conversions, and sales of assets.⁵⁶

Subchapter A sets forth the rules for adoption of plans of merger,⁵⁷ contents of plans of merger,⁵⁸ and effects of a merger.⁵⁹ Special provisions are also contained in Subchapter A relating to partnership mergers,⁶⁰ non-profit corporation mergers,⁶¹ short-form mergers,⁶² and mergers creating holding companies.⁶³ Section 10.005, governing mergers creating holding companies, does not apply to partnerships.⁶⁴ Section 10.006, governing short-form mergers, does not apply if a subsidiary organization that is a party to the merger is a partnership.⁶⁵

Section 10.009 contains a number of special provisions relating to mergers of partnerships; including limited partnerships.⁶⁶ In particular, included in these provisions is a requirement that the partnership agreement must contain provisions that authorize the merger provided for in the plan of merger adopted by the partnership.⁶⁷ These special provisions are similar to special provisions that were contained in the TRLPA and TRPA.⁶⁸

Section 10.010 contains special limitations on mergers involving non-profit corporations and should be carefully reviewed before a non-profit corporation effects a merger.⁶⁹

Subchapter B provides the rules for adoption and contents of plans of exchange,⁷⁰ and the

⁵⁴ *Id.* § 1.002(69-c)–(69-e).

⁵⁵ *Id.* §§ 10.151(b)(1)(G), 10.154(b)(1)(C), (D), amended by Tex. SB 860 (2015).

⁵⁶ *Id.* §§ 10.001–10.902.

⁵⁷ *Id.* § 10.001.

⁵⁸ *Id.* §§ 10.002–10.004.

⁵⁹ *Id.* § 10.008.

⁶⁰ *Id.* § 10.009.

⁶¹ *Id.* § 10.010.

⁶² *Id.* § 10.006.

⁶³ *Id.* § 10.005.

⁶⁴ *Id.* at (g).

⁶⁵ *Id.* § 10.006(i)(1).

⁶⁶ *Id.* § 10.009.

⁶⁷ *Id.* at (f).

⁶⁸ See TRLPA Art. 6132a-1 § 2.11(a); TRPA Art. 6132b-9.02(a).

⁶⁹ BUS. ORGS. § 10.010; see discussion *infra* Part XIII.A.

⁷⁰ *Id.* §§ 10.052–10.053.

effect of an exchange.⁷¹ Section 10.056 applies specifically to partnerships, including limited partnerships, and requires that the partnership agreement of each domestic partnership—whose partnership interests are to be acquired pursuant to the plan of exchange—must authorize the partnership interest exchange adopted by the partnership.⁷² All action required by the partnership agreement to approve the interest exchange must be taken in order to effect the exchange.⁷³

Subchapter C provides the rules for adoption and contents of plans of conversion, and the effect of a conversion.⁷⁴ Special provisions are set forth for partnership conversions⁷⁵ and non-profit corporation conversions.⁷⁶ Section 10.107 applies specifically to partnerships, including limited partnerships, and requires that the partnership agreement of each domestic partnership that is converting pursuant to the plan of conversion must authorize the partnership conversion adopted by the partnership.⁷⁷ All action required by the partnership agreement to approve the conversion must be taken in order to effect the conversion.⁷⁸ Section 10.108 prohibits the conversion of a non-profit corporation into a for-profit entity.⁷⁹

Subchapter C also includes Section 10.1025, which enables a relatively new type of transaction known as a “conversion and continuance.”⁸⁰ In this kind of transaction, an entity may be deemed formed and domesticated in the same organizational form both in Texas and in a non-United States jurisdiction.⁸¹ The concepts in these new provisions are based on similar concepts contained in the entity laws of the State of Delaware.⁸² Foreign entities sometimes use these kinds of provisions in order to provide a means to do business in the United States while avoiding adverse foreign tax ramifications.

Subchapter D provides the requirements for the contents and filing of certificates of merger, exchange, or conversion.⁸³

Subchapter E provides standard rules for abandonment of a plan of merger, exchange, or conversion.⁸⁴

Subchapter F authorizes domestic entities to sell, lease, or convey property⁸⁵ and clarifies

⁷¹ *Id.* § 10.055.

⁷² *Id.* § 10.056(1).

⁷³ *Id.* at (3).

⁷⁴ *Id.* §§ 10.101–10.106.

⁷⁵ *Id.* § 10.107.

⁷⁶ *Id.* § 10.108.

⁷⁷ *Id.* § 10.107(b).

⁷⁸ *Id.* at (c).

⁷⁹ *Id.* § 10.108.

⁸⁰ *Id.* § 10.1025.

⁸¹ *Id.* § 10.109.

⁸² *See, e.g.* DEL CODE ANN. tit. 8, § 390 (West 2015).

⁸³ BUS. ORGS. §§ 10.151–10.156.

⁸⁴ *Id.* §§ 10.201–10.203.

⁸⁵ *Id.* § 10.251.

standard rules for what kinds of approvals are required for certain property dispositions.⁸⁶ The requirements for signing a deed or conveyance are also set forth in this subchapter.⁸⁷

Subchapter G contains provisions intended to coordinate the Code with federal bankruptcy reorganization laws.⁸⁸ These provisions were derived primarily from the TBCA and TNPCA.

Subchapter H provides the rules and procedures for dissent and appraisal by owners with respect to a plan of merger, exchange or conversion or a sale of all or substantially all the assets of a domestic entity.⁸⁹ This subchapter only applies to domestic for-profit corporations, professional corporations, professional associations and real estate investment trusts.⁹⁰ Subchapter H does not apply to partnerships and limited liability companies unless their governing documents adopt the provisions of the subchapter.⁹¹

Subchapter Z contains miscellaneous provisions regarding the effect of the Code on creditors and Texas antitrust laws and clarifies that Chapter 10 does not limit the power of a domestic entity to acquire its ownership or membership interests through voluntary exchange or otherwise.⁹²

The 2015 amendments to the Code clarify various provisions of Chapter 10:

(a) Certain of the amendments clarify 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.”⁹³ An amendment to Section 1.002 of the Code added a corresponding definition of “owner liability,” based on the definition in the Model Business Corporation Act (the “MBCA”).⁹⁴ As personal liability had been understood in the provisions of Chapter 10 before the amendments, the term refers only to personal liability imposed on an owner or a member of an organization pursuant to statute or governing documents for the liabilities of the organization.⁹⁵

(b) Other provisions of Chapter 10 were amended to clarify that a formula can be used to determine the manner and basis of converting or exchanging ownership or membership interests in a plan of merger, plan of exchange or plan of conversion.⁹⁶ These amendments,

⁸⁶ *Id.* § 10.252.

⁸⁷ *Id.* § 10.253.

⁸⁸ *Id.* §§ 10.301–10.306.

⁸⁹ *Id.* §§ 10.351–10.368.

⁹⁰ *Id.* § 10.351(b).

⁹¹ *Id.* at (b) and (c).

⁹² *Id.* §§ 10.901–10.902.

⁹³ *Id.* §§ 10.001(e), 10.051(f), 10.101(f).

⁹⁴ *See* MODEL BUS. CORP. ACT § 1.40(15c).

⁹⁵ BUS. ORGS. § 1.002(63-a). Accordingly, “owner liability” does not include any liability or obligation that an owner or a member may incur or assume by a contract or an agreement, such as a guaranty of an organization’s obligations, other than an agreement contained within an organization’s governing document (such as a partnership agreement).

⁹⁶ *Id.* §§ 10.002(a)(5), 10.052(a)(5), 10.103(a)(5).

which were based conceptually on a recent amendment to section 152 of the Delaware General Corporation Law (the “DGCL”),⁹⁷ make express what has been implicit in the provisions before the amendments.

(c) Similarly, provisions of Chapter 10 were amended to clarify that the ownership or membership interests of an organization that is a party to a merger which survives the merger can remain outstanding rather than being converted or exchanged in the merger.⁹⁸ The amendments are based on recent amendments to the Delaware entity statutes⁹⁹ and confirm existing law and practice in mergers.

(d) Other amendments added provisions to clarify that any of the terms of a plan of merger, plan of exchange or plan of conversion may depend on facts ascertainable outside the plan if the manner that those facts operate is clearly and expressly stated in the plan.¹⁰⁰ The amendments are based on language in the DGCL¹⁰¹ and also confirm existing law and practice.

The 2015 amendments to Chapter 10 also included substantive changes in the law regarding filings in connection with a merger. Before the amendments, an amended and restated certificate of formation, or a restated certificate of formation, of a domestic filing entity that survives a merger could not be filed with the certificate of merger; only amendments to the certificate of formation of a surviving entity could be included in the certificate of merger. The 2015 amendments now permit the certificate of formation of a domestic filing entity that survives the merger (1) to be amended in connection with the merger by attaching to, and filing with, the certificate of merger either an amended and restated certificate of formation or a certificate of amendment to the certificate of formation, or (2) to be restated without amendment through attaching to, and filing with, the certificate of merger a restated certificate of formation that does not include any amendments to the certificate of formation.¹⁰²

VII. TITLE 2 – CORPORATIONS

A. For-Profit Corporations. Chapter 21 is the main chapter that governs for-profit corporations and was derived entirely from the TBCA. Although the provisions are substantially reorganized and subdivided into separate sections as compared to the TBCA provisions, most of the provisions contain no substantive changes from the TBCA.

Section 21.059(a) excludes from the requirement of having an organizational meeting of the initial Board of Directors a corporation that is created as a result of a conversion or merger

⁹⁷ See tit. 8, § 152.

⁹⁸ BUS. ORGS. §§ 10.002(a)(6), 10.008(a)(8).

⁹⁹ See tit. 8, § 251(b).

¹⁰⁰ BUS. ORGS. §§ 10.002(d), 10.052(c), 10.103(c). For this purpose, “facts” is defined to include the occurrence of any event, including a determination or action by any person.

¹⁰¹ See, e.g., tit. 8, §§ 251(b), 267.

¹⁰² BUS. ORGS. §§ 10.004(1), 10.151(b)(1), 10.151(d). An amendment to BUS. ORGS. §10.008(a)(6) also clarified that such an amended and restated certificate of formation or restated certificate of formation (without any amendment) constitutes the superseding and effective certificate of formation of that entity under BUS. ORGS. §3.063. *Id.* § 10.008(a)(6).

if the plan of conversion or merger states the bylaws and names the officers of the corporation.¹⁰³ If shares of a corporation are to be issued pursuant to a plan of conversion or a plan of merger, the consideration to be received for the shares and the manner of issuance of the shares can be as authorized, determined and provided by the plan of merger or plan of conversion.¹⁰⁴ In the absence of fraud in the transaction, the judgment of the party approving the plan of conversion or the plan of merger is conclusive in determining the value and sufficiency of the consideration received for the shares.¹⁰⁵

A committee of the Board of Directors of a corporation may not approve a plan of merger, interest exchange or conversion of the corporation.¹⁰⁶ Those powers are reserved to the Board of Directors.

Subchapter J of Chapter 21 contains the provisions that specify the approval procedures for a “*fundamental business transaction*.” These provisions supplement the provisions of Chapter 10 of the Code that contain the basic provisions governing fundamental business transactions. These provisions direct how the Board of Directors must adopt resolutions approving the fundamental business transaction and the procedure for submission of the transaction for approval by shareholders.¹⁰⁷ One section also cross references to the rights of dissent and appraisal for shareholders contained in Subchapter H of Chapter 10.¹⁰⁸

Section 21.452 requires that any corporation that is a party to the merger under Chapter 10 must approve the merger by the Board of Directors adopting a resolution approving the merger. If shareholder approval of the merger is required, the Board of Directors either must recommend that the plan of merger be approved by the shareholders of the corporation or direct that the plan of merger be submitted to the shareholders for approval without recommendation if the Board of Directors determines for any reason not to recommend approval. The Board of Directors may place conditions on the submission of the plan of merger to the shareholders. If the Board of Directors does not recommend the plan of merger be approved, it must communicate to the shareholders the reason for its determination to submit the plan of merger without recommendation. The Board of Directors can also change its mind and determine that the plan of merger is not advisable, and in that case, the plan of merger may be submitted to the shareholders of the corporation with the recommendation that the shareholders not approve the plan of merger. Notably these provisions specify that a plan of merger may include a provision requiring that the plan of merger be submitted to the shareholders regardless of whether the Board of Directors determines, after adopting a resolution or making a determination, that the plan of merger is not advisable and recommends that the shareholders not approve the plan of merger.¹⁰⁹

Section 21.453 specifies the requirements for approval by a corporation of a conversion

¹⁰³ *Id.* § 21.059(a).

¹⁰⁴ *Id.* §§ 21.158, 21.160(a).

¹⁰⁵ *Id.* § 21.162.

¹⁰⁶ *Id.* § 21.416(c)(3).

¹⁰⁷ *Id.* §§ 21.451–21.459.

¹⁰⁸ *Id.* § 21.460.

¹⁰⁹ *Id.* § 21.452.

under Chapter 10. The Board of Directors must adopt a resolution that approves the plan of conversion and recommends it for approval by the shareholders or directs that the plan of conversion be submitted to shareholders for approval without recommendation if the Board of Directors determines for any reason not to recommend approval. The Board of Directors may place conditions on the submission of the plan of conversion to the shareholders. If the Board of Directors approves the plan of conversion but does not recommend it for approval, the Board of Directors must communicate to the shareholders the reason for the Board's determination to submit the plan without a recommendation.¹¹⁰ If, after adopting the resolution approving the plan of conversion, the Board of Directors determines that the plan of conversion is not advisable, the plan of conversion may be submitted to the shareholders with a recommendation that the shareholders not approve the plan of conversion. Also, the plan of conversion may include a provision requiring that the plan of conversion be submitted to the shareholders regardless of whether the Board of Directors determines, after adopting a resolution or making a determination, that the plan of conversion is not advisable and recommends that the shareholders not approve the plan of conversion.¹¹¹

Section 21.454 specifies how a corporation, the shares of which are to be acquired in an exchange under Chapter 10, must approve the exchange. The Board of Directors must adopt a resolution that approves the plan of exchange and recommends that the plan of exchange be approved by the shareholders or directs that the plan of exchange be submitted to shareholders for approval without recommendation if it determines for any reason not to recommend approval. The Board of Directors may place conditions on the submission of the plan of exchange to the shareholders. If the Board of Directors does not recommend that the plan of exchange be approved by the shareholders, it must communicate to the shareholders the reason for the Board's determination to submit the plan of exchange to the shareholders without a recommendation. If, after adopting the resolution approving the plan of exchange, the Board of Directors determines that the plan of exchange is not advisable, the plan of exchange may be submitted to the shareholders with a recommendation that the shareholders not approve the plan of exchange. In addition, the plan of exchange may include a provision requiring that the plan of exchange be submitted to the shareholders regardless of whether the Board of Directors determines, after adopting a resolution or making a determination, that the plan of exchange is not advisable and recommends that the shareholders not approve the plan of exchange.¹¹²

A sale, lease, pledge, mortgage, assignment, transfer or other conveyance of an interest in real property or other assets of a corporation does not require the approval or consent of its shareholders unless otherwise provided by its certificate of formation or the transaction constitutes "*a sale of all or substantially all of the assets*" of the corporation.¹¹³ To approve the sale of all or substantially all of the assets, the Board of Directors of the corporation must adopt a resolution that approves the transaction and recommends that the sale of all or substantially all of the assets be approved by the shareholders or directs that the transaction be submitted to the shareholders for approval without recommendation if it determines for any reason not to recommend approval of the sale. The Board of Directors may place conditions on

¹¹⁰ *Id.* § 21.453.

¹¹¹ *Id.* at (f) and (g).

¹¹² *Id.* § 21.454.

¹¹³ *Id.* §§ 21.451(2), 21.455(a).

the submission of the proposed sale to the shareholders. If the Board of Directors does not recommend that the proposed sale be approved, it must communicate to the shareholders the reason for the Board's determination to submit the proposed sale to the shareholders without recommendation. After the approval of the sale by the shareholders, the Board of Directors may abandon the sale of all or substantially all of the assets of the corporation, subject to the rights of a third party under a contract relating to the assets, without further action or approval by the shareholders.¹¹⁴

Section 21.401 of the Code specifies that a director is entitled to consider, in discharging his or her duties, the long-term and short-term interests of the corporation and its subsidiaries. This includes the possibility that those interests may be best served by the continued independence of the corporation. Thus, the members of the Board of Directors, in the exercise of their business judgment, may determine to reject a merger or acquisition offer from a third party if they determine such merger or acquisition is not in the long-term or short-term interests of the corporation and its subsidiaries, including the corporation's continued independence.¹¹⁵ Section 21.401(c) provides that a director is also entitled to consider any "social purposes" specified in the corporation's certificate of formation in discharging the director's duties.¹¹⁶ Section 21.401(d) provides the same authority to and protection for officers of the corporation in discharging the officers' duties. Another provision in Chapter 21 specifies that the authority and protection provided in Section 21.401(c) and (d) regarding for-profit corporations that have a social purpose stated in their certificate of formation are not intended to prohibit or limit a director or officer of other for-profit corporations from considering, approving or taking an action that promotes or has the effect of promoting a social, charitable or environmental purpose.¹¹⁷

If a fundamental business transaction is required to be submitted to the shareholders of the corporation for approval, the corporation must notify each shareholder that the fundamental business transaction is being submitted for approval at a meeting of shareholders, regardless of whether the shareholders are entitled to vote on the matter.¹¹⁸ If the fundamental business transaction is a merger, conversion or interest exchange, the notice must contain or be accompanied by a copy or summary of the plan of merger, conversion or interest exchange and the notice of the shareholders' dissent and appraisal rights as required by Section 10.355.¹¹⁹ Notice of the meeting must be given not later than the 21st day before the day of the meeting and state that the purpose of the meeting is to consider the fundamental business transaction.¹²⁰

Unless otherwise provided by the certificate of formation of the corporation, the affirmative vote of the holders of at least two-thirds of the outstanding shares of the corporation entitled to vote on a fundamental business transaction is required to approve the

¹¹⁴ *Id.* § 21.455.

¹¹⁵ *Id.* § 21.401(b).

¹¹⁶ *Id.* § 21.401(c); *see also id.* § 1.002(82-a) (defining social purposes).

¹¹⁷ *Id.* § 21.401(e).

¹¹⁸ *Id.* § 21.456(a).

¹¹⁹ *Id.* at (b). As described below in Part XIII.H of this article, shareholders also have dissent or appraisal rights in certain types of mergers in which a shareholder vote on the merger is not required.

¹²⁰ *Id.* at (c).

transaction.¹²¹

Unless otherwise provided in the certificate of formation, shares of a class or series that are not otherwise entitled to vote on matters submitted to shareholders generally are not entitled to vote for the approval of a fundamental business transaction. However, Section 21.458(a) specifies that separate voting by class or series of shares is required for approval of a plan of merger or conversion if the plan contains a provision that would require approval by that class or series of shares under Section 21.364 if the provision was contained in a proposed amendment to the certificate of formation or if the class or series is entitled under the certificate of formation to vote as a class or series on the plan of merger or conversion.¹²² Similarly, Section 21.458(b) requires that the separate voting by a class or series of shares of a corporation is required for approval of a plan of exchange if those shares are to be exchanged under the terms of the plan or the class or series is entitled to such separate vote under the certificate of formation.¹²³ Separate voting by a class or series of shares is required for approval of the sale of all or substantially all of the assets of a corporation only if the certificate of formation requires the separate vote on the sale.¹²⁴ If a class or series of shares is entitled to vote separately, the affirmative vote of the holders of at least two-thirds of those shares must approve the fundamental business transaction except as provided by the Code.¹²⁵

No approval by the shareholders of a corporation that is simply a party to the plan of merger is required unless that corporation is also a “*party to the merger.*”¹²⁶ Section 21.459 specifies certain types of mergers that do not require the approval by the shareholders of a corporation.¹²⁷

A corporation may convey its real property when authorized by appropriate resolution of the Board of Directors.¹²⁸ Similarly, the Board of Directors may authorize a pledge, mortgage, deed of trust or trust indenture without authorization or consent of its shareholders unless otherwise required by its certificate of formation.¹²⁹

Subchapter L of Chapter 21 contains provisions relating to derivative proceedings in the right of a corporation. Section 21.552 (formerly Section 21.552(a)) and existing Texas case law do not afford standing to a shareholder to bring or continue a derivative proceeding after a merger if the shareholder otherwise does not have standing (e.g., because the shareholder is no longer a shareholder of a surviving corporation in the merger).¹³⁰

¹²¹ *Id.* § 21.457(a).

¹²² *Id.* § 21.458(a).

¹²³ *Id.* at (b).

¹²⁴ *Id.* at (c).

¹²⁵ *Id.* § 21.457(c).

¹²⁶ *Id.* at (d).

¹²⁷ *Id.* § 21.459.

¹²⁸ *Id.* § 21.462.

¹²⁹ *Id.* § 21.461.

¹³⁰ *See, e.g., Somers v. Crane*, 295 S.W.3d 5, 13 (Tex. App.—Houston [1st Dist.] 2009, pet. denied); *see also* BUS. ORGS. § 21.552.

Subchapter M of Chapter 21 applies to business combinations involving an “*issuing public corporation*” with its “*affiliated shareholder*,” which is a shareholder that is the “*beneficial owner*” of more than 20 percent of the outstanding voting shares of the corporation, or other sale, lease, exchange, mortgage, pledge, transfer or other disposition in a transaction or a series of transactions with an affiliated shareholder of assets of the issuing public corporation. An “*issuing public corporation*” means a domestic corporation that has 100 or more shareholders of record, a class or series of its voting shares registered under the Securities Exchange Act of 1934, as amended, or a class or series of its voting shares qualified for trading on a national securities exchange.¹³¹ The definition of “*beneficial owner*” is a broad one, similar to the one set forth in Rule 13d-3 adopted by the Securities and Exchange Commission for the Securities Exchange Act of 1934, as amended.¹³² These business combination provisions prohibit a business combination with an affiliated shareholder during a three-year period immediately following the affiliate shareholder’s share acquisition date.¹³³ The three-year moratorium period does not apply, however, if the business combination or the purchase or acquisition of shares made by the affiliated shareholder is approved by the Board of Directors of the issuing public corporation before the share acquisition date or the business combination is approved by the affirmative vote of the holders of at least two-thirds of the outstanding voting shares not beneficially owned by the affiliated shareholder.¹³⁴ Careful review of the provisions of Subchapter M must be undertaken if a corporation constitutes an issuing public corporation and engages in any kind of transaction with a shareholder that is a beneficial owner of more than 20 percent of its outstanding voting shares.

B. Nonprofit Corporations. Chapter 22 is the main chapter that governs non-profit corporations and was derived entirely from the TNPCA. Although the provisions are substantially reorganized and subdivided into separate sections as compared to the TNPCA provisions, most of the provisions contain no substantive changes from the TNPCA.

Subchapter D of Chapter 22 introduces the concept of “*fundamental action*,” which is defined to include (i) an amendment of a certificate of formation, (ii) a voluntary winding up under Chapter 11 of the Code, (iii) a revocation of a voluntary decision to wind up under Section 11.151, (iv) a cancellation of an event requiring winding up under Section 11.512, (v) a reinstatement under Section 11.202, (vi) a distribution plan under Section 22.305, (vii) a plan of merger, conversion or exchange, or (viii) a sale of all or substantially all of the assets of the corporation.¹³⁵ Each of these actions in the TNPCA had their own separate voting provisions, which created a significant amount of redundancy. The Code collapses these redundant provisions into one section which specifies the vote required to approve a fundamental action.¹³⁶

Subchapter F contains the provisions that specify the approval procedures for a “*fundamental business transaction*,” which means a merger, interest exchange, conversion or

¹³¹ BUS. ORGS. § 21.601(1).

¹³² This definition applies only for purposes of subchapter M of Chapter 21. *See id.* § 21.603.

¹³³ *Id.* § 21.606.

¹³⁴ *Id.*

¹³⁵ *Id.* § 22.164(a).

¹³⁶ *Id.* § 22.164.

sale of all or substantially all of the corporation's assets.¹³⁷ These provisions supplement the provisions of Chapter 10 that contain the basic provisions regarding fundamental business transactions. The provisions direct (i) how the Board of Directors must adopt resolutions approving the fundamental business transaction and the procedure for submission of the transaction for approval by members or (ii) how the members must approve the fundamental business transaction if management of the corporation is vested in its members.¹³⁸

C. Special-Purpose Corporations. Chapter 23 applies to special-purpose corporations that are created under this chapter or under a separate statute outside the Code. Subchapter A contains general provisions specifying that Chapter 21 of the Code applies to these special-purpose corporations if they are organized for-profit, but only to the extent not inconsistent with the special statute under which the corporation was formed.¹³⁹ On the other hand, if the special-purpose corporation is organized not for-profit, then Chapter 22 applies to it, to the extent not inconsistent with the special statute.¹⁴⁰ The provisions also authorize the special statute to specifically incorporate Title 1 and Chapter 21 or 22 of the Code to supplement the special statute.¹⁴¹

VIII. TITLE 3 – LIMITED LIABILITY COMPANIES

Title 3 has only one chapter, Chapter 101, and applies solely to limited liability companies. The Code uses the term “*company agreement*” in lieu of the old term “regulations” used in the TLLCA.¹⁴² The new term was intended to emphasize the underlying contractual nature of this governing document for a limited liability company. Nevertheless, having only one member does not make the company agreement unenforceable.¹⁴³

The most significant change in Title 3 from the TLLCA was the change in structure of how the provisions are applied. The TLLCA contained numerous provisions that were expressly qualified with the language “unless otherwise provided in the articles of organization or regulations” or similar limitations. In the interest of clarity and economy of language, the Code takes the approach that every provision in Title 3 governing limited liability companies may be waived or modified by the company agreement except as specified in Section 101.054. In the absence of a governing provision in the company agreement, the provisions of Chapter 101 will apply as “default” provisions. Section 101.054 specifies what provisions of Chapter 101 cannot be waived or modified in the company agreement.

Subchapter H of Chapter 101 contains provisions that govern meetings and voting by the governing authority, members or a committee of the governing authority of the company.¹⁴⁴

¹³⁷ *Id.* § 1.002(32).

¹³⁸ *Id.* §§ 22.251–22.253, 22.256–22.257.

¹³⁹ *Id.* § 23.001(a)(1).

¹⁴⁰ *Id.* at (a)(2).

¹⁴¹ *Id.* at (b).

¹⁴² See *id.* §101.001(1) (Defining “company agreement” to be any agreement, written or oral, of the members concerning the affairs or the conduct of the business of a limited liability company).

¹⁴³ *Id.*

¹⁴⁴ *Id.* § 101.351.

Provisions are set forth that are supplemental to Chapter 6 governing notices of meetings.¹⁴⁵ Section 101.356 specifies the vote required to approve certain actions, including fundamental business transactions.¹⁴⁶ Provisions also authorize the use of proxies¹⁴⁷ and action by less than unanimous written consent.¹⁴⁸ Section 101.359 authorizes actions to be taken in less formal manner, including valid consents based on knowing silence.¹⁴⁹

Section 101.052(e) of the Code states that a company agreement of a limited liability company may provide rights to any person, including a person who is not a party to the agreement, to the extent set forth in the agreement.¹⁵⁰ Such a person may include a manager, officer, or creditor of the limited liability company, and those rights may include rights regarding all or certain fundamental business transactions of the limited liability company if the members so desire.

Section 101.605 of the Code states that a series of a limited liability company has the power and capacity, in the series' name, to (among other things) sue, to contract, to acquire and sell assets, to grant liens in its assets and to exercise any powers or privileges as necessary or appropriate to the conduct, promotion or attainment of the business, purpose or activities of the series. Also, Section 101.609(c) provides that a series of a limited liability company and the governing persons and officers associated with the series have, among other things, the powers and rights regarding the sale, lease and conveyance of property described in Subchapter F of Chapter 10 of the Code. It is important to note, however, that, because a series is not a separate domestic entity,¹⁵¹ the Code does not provide any express authority to a series to engage in a merger, interest exchange or conversion under Subchapters A, B or C, respectively, of Chapter 10 of the Code.

IX. TITLE 4 – PARTNERSHIPS

A. General. Title 4 is divided into four Chapters. Chapter 151, the first chapter, contains only three sections that contain general provisions that apply to all types of partnerships. These general provisions include general definitions¹⁵² and specify how a person has knowledge or notice of a fact for purposes of Title 4.¹⁵³

B. General Partnerships. Chapter 152 is the main chapter that governs general partnerships and was derived entirely from the TRPA. Although the provisions are substantially reorganized and subdivided into separate sections as compared to the TRPA provisions, most of the provisions contain no substantive changes from the TRPA.

¹⁴⁵ *Id.* § 101.352.

¹⁴⁶ *Id.* § 101.356.

¹⁴⁷ *Id.* § 101.357.

¹⁴⁸ *Id.* § 101.358.

¹⁴⁹ *Id.* § 101.359.

¹⁵⁰ *Id.* § 101.052(e).

¹⁵¹ *Id.* § 101.622.

¹⁵² *Id.* § 151.001.

¹⁵³ *Id.* §§ 151.002, 151.003.

Subchapter A contains general provisions, including Section 152.001, which contains most of the definitions applicable to Chapter 152. Section 152.002 is particularly important because it provides that a partnership agreement generally controls over contrary provisions in Chapter 152 subject to certain restrictions on the contents of a partnership agreement. A partnership agreement cannot eliminate certain duties, rights and powers of partners, as described in Section 152.002. The section also specifies what provisions of can be waived or modified in the partnership agreement, with certain exceptions.

Chapter 152 does not contain any specific provisions relating to fundamental business transactions or their approval by partners. Those provisions are located in special sections in Chapter 10.

C. Limited Partnerships. Chapter 153 is the main chapter that governs limited partnerships and was derived entirely from the TRLPA. Although the provisions are substantially reorganized and subdivided into separate sections as compared to the TRLPA provisions, most of the provisions contain no substantive changes from the TRLPA.

Subchapter A contains general provisions relating to limited partnerships. Section 153.003 clarifies that the provisions of Chapter 152 governing general partnerships also apply to limited partnerships, except that the powers and duties of a limited partner are not governed by Chapter 152 in any manner inconsistent with the nature and role of a limited partner as contemplated by Chapter 153.¹⁵⁴ Section 153.004 is a particularly important provision that clarifies what provisions of Chapter 153 can be waived or modified, and what provisions cannot be waived or modified, in the partnership agreement of the limited partnership.

Chapter 153 does not contain any specific provisions governing fundamental business transactions or their approval by partners. Those provisions are located in special sections in Chapter 10. A limited partner does not participate in the control of the business and lose its liability shield simply because the limited partner proposes, approves or disapproves a sale or other transfer of any asset of the limited partnership or a merger, conversion or interest exchange of the limited partnership.¹⁵⁵

D. Both General and Limited Partnerships. Chapter 154, the fourth Chapter, contains provisions applicable to both general and limited partnerships. Those provisions generally concern the nature of an interest in a partnership, certain authorized rights that may be set forth in a partnership agreement and certain partnership transactions and relationships. Section 154.104 states that a partnership agreement of a general or limited partnership may provide rights to any person, including a person not a party to the agreement, to the extent set forth in the agreement. Such a person may include, for example, an officer or a creditor of the partnership.

¹⁵⁴ The term “other limited partnership provisions” in Section 153.003 is defined in Section 153.001 to mean the provisions of Title 1 and Chapters 151 and 154 to the extent applicable to limited partnerships.

¹⁵⁵ *Id.* § 153.103(9)(C), (N).

X. TITLE 5 – REAL ESTATE INVESTMENT TRUSTS

Title 5 has only one chapter, Chapter 200. Subchapter A contains the general provisions, including the critical definition of what constitutes a real estate investment trust.¹⁵⁶ Subchapter A contains supplemental provisions regarding the powers of a real estate investment trust in addition to those provisions contained in Chapter 2.¹⁵⁷ These general provisions also include provisions governing ultra vires acts¹⁵⁸ and the requirements for signing filing instruments by officers.¹⁵⁹ Subchapter A incorporates the provisions of Chapters 20 and 21 governing for-profit corporations unless there is a conflict with any provision in Chapter 200.¹⁶⁰ Section 200.002 specifies that an unincorporated trust that does not meet the requirements of Chapter 200 is an unincorporated association. In lieu of a Board of Directors, a real estate investment trust has trust managers. A committee of the trust managers may not approve a plan of merger or a share exchange of the real estate investment trust, because that power is reserved to the board of trust managers.¹⁶¹

Subchapter I contains the provisions that specify the approval procedures for a “*fundamental business transaction*,” which means a merger, interest exchange, conversion or sale of all or substantially all of the real estate investment trust’s assets.¹⁶² These provisions supplement the provisions of Chapter 10 that contain the basic provisions governing fundamental business transactions. These provisions direct how the trust managers must adopt resolutions approving the fundamental business transaction and the procedure for submission of the transaction for approval by shareholders.¹⁶³ One section also cross-references to the rights of dissent and appraisal for shareholders contained in Subchapter H of Chapter 10.¹⁶⁴

XI. TITLE 6 – ASSOCIATIONS

A. General Provisions. Title 6 contains only two chapters. Chapter 251 governs cooperative associations. Chapter 252 governs unincorporated non-profit associations.

B. Cooperative Associations. Subchapter A contains general provisions, including the definitions that are applicable to Chapter 251.¹⁶⁵ In addition, Subchapter A incorporates the provisions of Chapters 20 and 22 governing non-profit corporations, unless there is a conflict with any provision in Chapter 251.¹⁶⁶ Significantly, Section 251.003 specifies that Chapter 251 does not apply to a corporation or association organized on a cooperative basis under another statute of the State of Texas, other than Chapter 251, unless that other statute specifically states

¹⁵⁶ *Id.* § 200.001.

¹⁵⁷ *Id.* § 200.005.

¹⁵⁸ *Id.* § 200.004.

¹⁵⁹ *Id.* § 200.006.

¹⁶⁰ *Id.* § 200.002.

¹⁶¹ *Id.* § 200.311(c)(3).

¹⁶² *Id.* § 1.002(32).

¹⁶³ *Id.* §§ 200.402–200.409.

¹⁶⁴ *Id.* § 200.410.

¹⁶⁵ *Id.* § 251.001.

¹⁶⁶ *Id.* § 251.002.

that Chapter 251 does apply. Accordingly, there are many types of cooperative associations that are formed and do business in Texas that are not governed by Chapter 251. Nevertheless, even though not subject to Chapter 251, if they are formed as corporations, they may be subject to the non-profit corporation provisions of Chapter 22 by virtue of Chapter 23's provisions governing special-purpose corporations formed under statutes outside the Code.¹⁶⁷

Because Chapter 251 incorporates the provisions of Chapter 22 governing non-profit corporations, it does not have any specific provision governing the approval of fundamental business transactions.

C. Unincorporated Nonprofit Associations. Chapter 252 contains almost verbatim the former provisions of the TUUNAA. Very few changes were made from that prior statute. However, Section 252.017 specifies that Chapters 1 and 4 and, if a non-profit association designates an agent for service of process, Subchapter E of Chapter 5 apply to a non-profit association. The same section specifies that no other provisions of the Code (which include Chapter 10) apply to a non-profit association. Chapter 252 does not contain any specific provision authorizing mergers or conversions or governing the approval of fundamental business transactions. Based on this lack of authority and informal discussions with members of the staff of the Texas Secretary of State, it is our understanding that the Secretary of State's office does not accept filings of certificates of merger or conversion for unincorporated non-profit associations.

XII. TITLE 7 – PROFESSIONAL ENTITIES.

A. General Provisions. Title 7 is divided into four chapters. Chapter 301 contains general provisions relating to all professional limited liability companies, professional associations and professional corporations. It should be noted that Section 301.001 specifically exempts partnerships, including limited liability partnerships, from the provisions of Title 7.¹⁶⁸ Thus, partnerships can provide professional services assuming the regulatory law governing the professional service permits practice of that profession in a partnership entity.

Section 301.003 contains definitions that apply generally throughout, including definitions of professional corporation, professional association, professional limited liability company and professional service.¹⁶⁹

B. Professional Associations. Chapter 302 applies only to professional associations and was derived from the TPAA. This Chapter incorporates the provisions of Chapters 20 and 21 governing for-profit corporations, unless there is a conflict with any provision in Title 7.¹⁷⁰ Because of these incorporated provisions, this Chapter does not have any special provision governing approval of fundamental business transactions.

C. Professional Corporations. Chapter 303 contains special provisions applying only to

¹⁶⁷ *Id.* §§ 23.001–23.003.

¹⁶⁸ *Id.* § 300.001(c).

¹⁶⁹ *See id.* § 301.003(2), (3), (6), (8).

¹⁷⁰ *Id.* § 302.001.

professional corporations and was derived solely from the TPCA. This Chapter incorporates the provisions of Chapters 20 and 21 governing for-profit corporations, unless there is a conflict with any provision in Title 7.¹⁷¹ Because of these incorporated provisions, this Chapter does not contain any special provision governing approval of fundamental business transactions.

D. Professional Limited Liability Companies. Chapter 304 contains only one section and applies solely to professional limited liability companies. That section incorporates the provisions of Chapter 101 governing limited liability companies generally, unless there is a conflict with any provision in Title 7.¹⁷² Because of these incorporated provisions, this Chapter does not contain any special provision governing approval of fundamental business transactions.

XIII. FUNDAMENTAL BUSINESS TRANSACTIONS

A. Mergers. The Code does not have the concept of “consolidation” of entities. That concept is subsumed within the definition of “merger.”¹⁷³ That definition includes the combination of one or more domestic entities with one or more domestic entities or non-code organizations resulting in the creation of one or more new domestic entities or non-code organizations.

A domestic entity may effect a merger if each domestic entity that is a party to the merger acts on and approves the plan of merger in the manner prescribed in the Code for the approval of mergers by the domestic entity.¹⁷⁴ The notice of the meeting at which the merger is approved must include an additional notice if the domestic entity is subject to dissenters’ rights.¹⁷⁵ If one or more non-Code organizations is a party to the merger or is to be created by the plan of merger, the merger must be permitted by the laws of the state or country under whose law each non-Code organization is incorporated or organized, or the governing documents of each non-Code organization if the documents are not inconsistent with the law under which a non-Code organization is incorporated or organized.¹⁷⁶ In addition, each non-Code organization that is a party to the merger must comply with the applicable laws under which it is incorporated or organized and the governing documents of the non-Code organization. A domestic entity that is a party to the merger may not merge if an owner or a member of that entity will, as a result of the merger, become subject to owner liability, without that owner’s or member’s consent, for a liability or other obligation of any other person.¹⁷⁷

The plan of merger must be in writing (though it need not be signed) and must include, among other things, the manner and basis of converting or exchanging any of the ownership or membership interests of each organization that is a party to the merger into: (A) ownership

¹⁷¹ *Id.* § 303.001.

¹⁷² *Id.* § 304.001.

¹⁷³ *Id.* § 1.002(55).

¹⁷⁴ *Id.* § 10.001(a)–(b).

¹⁷⁵ *Id.* §§ 10.001(c), 10.355(b).

¹⁷⁶ *Id.* § 10.001(d).

¹⁷⁷ *Id.* §§ 10.001(e), 1.002(63-a).

interests, membership interests, obligations, rights to purchase securities, or other securities of one or more of the surviving or new organizations; (B) cash; (C) other property, including ownership interests, membership interests, obligations, rights to purchase securities, or other securities of any other person or entity; or (D) any combination of the foregoing items.¹⁷⁸ If any of the ownership or membership interests are to be canceled rather than converted or exchanged, or if any of the ownership or membership interests of a surviving organization are to remain outstanding, the plan of merger must so state.¹⁷⁹ “Any of the terms of the plan of merger may be made dependent on facts ascertainable outside the plan if the manner in which those facts operate on the terms of the merger is clearly and expressly stated in the plan.”¹⁸⁰

A plan of merger may treat differently the owners or members in the same class or series.¹⁸¹ Section 10.002(c) of the Code states that an ownership or membership interest of a particular series or class may be canceled while other ownership or membership interests of the same class or series are converted or exchanged for other consideration as a result of the merger.

If applicable, the plan of merger must include: (1) the certificate of formation of each new domestic filing entity and the governing documents of each new domestic nonfiling entity to be created by the merger, and (2) the governing documents of each non-Code organization that is to survive the merger or to be created by the plan of merger and that is not organized under the laws of any state or the United States or required to file its certificate of formation or similar document under which the entity is organized with the appropriate governmental authority.¹⁸²

If more than one organization is to survive or to be created by the plan of merger, the plan of merger must include: (1) the manner and basis of allocating and vesting the property of each organization that is a party to the merger among one or more of the surviving or new organizations; (2) the name of each surviving or new organization that is primarily obligated for the payment of the fair value of an ownership or membership interest of an owner or member of a domestic entity subject to dissenter’s rights that is a party to the merger and who complies with the requirements for dissent and appraisal under the Code; and (3) the manner and basis of allocating each liability and obligation of each organization that is a party to the merger, or adequate provisions for the payment and discharge of each liability and obligation, among one or more of the surviving or new organizations.¹⁸³ Upon effectiveness of the merger, all rights, title and interest to all real estate and other property owned by each organization that is a party to the merger is allocated to and vested, subject to any existing liens or other encumbrances on the property, in one or more of the surviving or new organizations as provided in the plan of merger without reversion or impairment, any further act or deed or any transfer or assignment having occurred.¹⁸⁴ In addition, all of the liabilities and obligations of

¹⁷⁸ See *id.* §10.002(a)(5) (a formula may be used as the manner and basis of the conversion or exchange).

¹⁷⁹ *Id.* at (a)(6).

¹⁸⁰ *Id.* at (d).

¹⁸¹ *Id.* at (c).

¹⁸² *Id.* at (a).

¹⁸³ *Id.* § 10.003.

¹⁸⁴ *Id.* § 10.008(a)(2).

each organization that is a party to the merger are allocated to one or more of the surviving or new organizations in the manner provided by the plan of merger, and that organization is the primary obligor for the liability or obligation; and except as otherwise provided by the plan of merger or by law or contract, no other party to the merger, other than a surviving domestic entity or non-Code organization liable or otherwise obligated at the time of the merger, and no other new domestic entity or non-Code organization created under the plan of merger is liable for the debt or other obligation.¹⁸⁵ “The surviving or new organization named in the plan of merger as primarily liable to pay the fair value of an ownership or membership interest to a dissenting owner or member is the primary obligor for that payment and all other surviving or new organizations are secondarily liable for that payment.”¹⁸⁶ Other effects of a merger are specified in Section 10.008(a) of the Code.

If the plan of merger does not allocate a property, liability or obligation to any party of the merger, the unallocated property is owned in undivided interest by, and the liability or obligation is the joint and several liability and obligation of, each of the surviving and new organizations, pro rata to the total number of surviving and new organizations resulting from the merger.¹⁸⁷ If the surviving organization in a merger is not a domestic entity, the organization must register to transact business in Texas if the entity is required to register for that purpose by another provision of the Code.¹⁸⁸ In addition, such surviving organization is considered to have appointed the Texas Secretary of State as its agent for service of process in a proceeding to enforce any obligation of a domestic entity that is a party to the merger and to have agreed to promptly pay to the dissenting owners or members of each domestic entity that is a party to the merger who have the right of dissent and appraisal under the Code, any amount to which they are entitled under the Code.¹⁸⁹

The filing of a certificate of merger in the state of Texas is required if any domestic entity that is a party to the merger is a filing entity or any domestic entity to be created under the plan of merger is a filing entity.¹⁹⁰

The certificate of merger that must be filed in the state of Texas must contain either a copy of the plan of merger or alternative required statements. The alternative required statements include, among other things, the amendments or changes to the certificate of formation of each filing entity that is a party to the merger or, if no amendments are desired to be effected by the merger, a statement to that effect. In addition, the certificate of merger, if the plan of merger is not attached, must state that a signed plan of merger is on file with the principal place of business of each surviving, acquiring or new domestic entity or non-Code organization, and the address of each principal place of business, and that a copy of the plan of merger will be on written request furnished without cost to any owner or member of any domestic entity that is a party to or created by the plan of merger. If the merger has multiple surviving domestic entities

¹⁸⁵ *Id.* at (a)(3)–(4).

¹⁸⁶ *Id.* at (a)(9).

¹⁸⁷ *Id.* at (b) (We believe that it would be unusual for the parties to desire the statutory “default” allocation of property, liabilities or obligations.).

¹⁸⁸ *Id.* at (d).

¹⁸⁹ *Id.* at (c)(2).

¹⁹⁰ *Id.* § 10.151(a)(1).

or non-Code organizations, the plan of merger must also be provided to any creditor or obligee of the parties to the merger at the time of the merger if a liability or obligation is then outstanding.¹⁹¹ If no approval of the owners or members of any domestic entity that was a party to the merger is required by the Code, a statement to that effect must be included in the certificate of merger in any event.¹⁹² Finally, the certificate of merger must state that the plan of merger has been approved as required by the laws of the jurisdiction of formation and the governing documents of each organization that is a party to the merger.¹⁹³

The Code expands the provisions governing the formation of holding companies without requiring the vote of owners or members from for-profit corporations to other types of entities, except partnerships.¹⁹⁴ Restructuring opportunities are available to the governing authority without the hassle and expense of solicitation of and approval by owners or members.

The so-called “*short-form*” merger provision in the Code applies to all types of entities, except that it does not apply if a subsidiary organization that is a party to the merger is a partnership (including a limited partnership).¹⁹⁵ Under the prior statutes, that type of merger was restricted to limited liability companies and business corporations. Thus, a parent partnership may merge with one or more non-partnership subsidiary entities in which it owns at least 90% of the voting interest without approval of the subsidiaries’ owners.

The 2015 amendments to the Code added provisions to Section 21.459 to authorize 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.¹⁹⁶ The process consists of a “front-end” tender or exchange offer for the target corporation’s shares by the acquirer followed by a “back-end” merger between the acquirer and the target. 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 tender or exchange offer must be for all of the shares of the target, other than those owned by the acquirer or its affiliates.¹⁹⁷ (2) The plan of merger must expressly require or permit reliance on Section 21.459(c).¹⁹⁸ (3) Upon consummation of the tender or exchange offer, 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 target.¹⁹⁹ (4) 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.²⁰⁰ (5) The

¹⁹¹ *Id.* at (b)(1)(H).

¹⁹² *Id.* at (b)(2).

¹⁹³ *Id.* at (b)(3).

¹⁹⁴ *Id.* § 10.005(g).

¹⁹⁵ *Id.* § 10.006(i)(1).

¹⁹⁶ *Id.* § 21.459.

¹⁹⁷ *Id.* at (c)(2).

¹⁹⁸ *Id.* at (c)(1)(A).

¹⁹⁹ *Id.* at (c)(3).

²⁰⁰ *Id.* at (c)(5).

merger must be effected as soon as practicable after the tender or exchange offer.²⁰¹ (6) The target shareholders must be granted dissenters' rights.²⁰² Special definitions of certain terms, which conform to typical tender-offer practice, were also added to Section 21.459.²⁰³ These amendments to Section 21.459 are based on section 251(h) of the DGCL as adopted in 2013 and amended in 2014. As described below in Part XIII.H of this article, amendments were also made to various provisions of Chapter 10 to confirm that dissenters' rights apply to a back-end merger under Section 21.459(c).

One or more domestic nonprofit corporations and non-Code organizations may merge into one or more foreign nonprofit entities that continue as the surviving entity or entities. However, a domestic nonprofit corporation may not merge into another entity if the domestic nonprofit corporation would, because of the merger, lose or impair its charitable status.²⁰⁴ In addition, a domestic nonprofit corporation may not merge with a foreign for-profit entity if the domestic nonprofit corporation does not continue as the surviving entity.²⁰⁵ On the other hand, "one or more domestic or foreign for-profit entities or non-Code organizations may merge into one or more domestic nonprofit corporations that continue as the surviving entity or entities."²⁰⁶

The partnership agreement of each domestic partnership (including a limited partnership) that is a party to the merger must contain provisions that authorize the merger provided for in the plan of merger adopted by the partnership. Each domestic partnership that is a party to the merger must approve the plan of merger in the manner prescribed in its partnership agreement. A partner in a domestic partnership that is a party to the merger but does not survive is treated as a partner who withdrew from the non-surviving domestic partnership as of the effective date of the merger. The Code contains other special provisions governing mergers of a domestic partnership.²⁰⁷

B. Conversions. A domestic entity may convert into a different type of domestic entity or a non-Code organization by adopting a written plan of conversion.²⁰⁸ Certain domestic entities are subject to dissenters' rights and must provide additional content in its notices to owners in connection with the approval of the plan of conversion.²⁰⁹

A conversion may not take effect if the conversion is prohibited by or inconsistent with the laws of the converted entity's jurisdiction of formation, and the formation, incorporation or organization of the converted entity under the plan of conversion must be effected in compliance with those laws pursuant to the plan of conversion.²¹⁰

²⁰¹ *Id.* at (c)(1)(B).

²⁰² *Id.* § 10.354(a)(1)(F).

²⁰³ *Id.* § 21.459(d)-(e).

²⁰⁴ *Id.* § 10.010(a).

²⁰⁵ *Id.* at (c).

²⁰⁶ *Id.* at (d).

²⁰⁷ *Id.* § 10.009.

²⁰⁸ *Id.* § 10.101(a).

²⁰⁹ *Id.* §§ 10.101(c), 10.355.

²¹⁰ *Id.* § 10.101(d).

A domestic entity may not convert if an owner or a member of the domestic entity will, as a result of the conversion, become subject to owner liability, without the consent of the owner or member, for a liability or other obligation of the converted entity.²¹¹

A non-Code organization may convert into a domestic entity by adopting a plan of conversion and taking any action that may be required for a conversion under the law of the organization's jurisdiction of formation and the organization's governing documents.²¹² The conversion must be permitted by the laws under which the non-Code organization is incorporated or organized or by its governing documents, which may not be inconsistent with the laws of the jurisdiction in which the non-Code organization is incorporated or organized.²¹³

The plan of conversion must be in writing (though it need not be signed) and must include, among other things, the manner and basis of converting the ownership or membership interests of the converting entity.²¹⁴ Any of the terms of the plan of conversion may be made dependent on facts ascertainable outside the plan if the manner in which those facts operate on the terms of the conversion is clearly and expressly stated in the plan.²¹⁵

The plan of conversion also must include any certificate of formation required to be filed under the Code if the converted entity is a filing entity.²¹⁶ Upon the effectiveness of the conversion, the converting entity continues to exist without interruption in the organizational form of the converted entity rather than in the organizational form of the converting entity, and all rights, title and interest to all property owned by the converting entity continues to be owned, subject to any existing liens or other encumbrances on the property, by the converted entity in the new organizational form without (1) reversion or impairment, (2) further act or deed, or (3) any transfer or assignment having occurred. All liabilities and obligations of the converting entity continue to be liabilities and obligations of the converted entity in the new organizational form without impairment or diminution because of the conversion. If the converted entity is a non-Code organization, the converted entity is considered to have appointed the Texas Secretary of State as its agent for service of process in a proceeding to enforce any obligation or the rights of dissenting owners or members of the converting domestic entity and agree that the converted entity will promptly pay the dissenting owners or members of the converting domestic entity the amount, if any, to which they are entitled under the Code.²¹⁷

If the converted entity is a domestic partnership (including a limited partnership), the partnership agreement must contain provisions that authorize the conversion provided for in the plan of conversion adopted by the partnership. The domestic partnership must approve the plan of conversion in the manner provided in its partnership agreement.²¹⁸ A domestic non-

²¹¹ *Id.* §§ 10.101(f), 1.002(63-a).

²¹² *Id.* § 10.102(a)-(b).

²¹³ *Id.* at (e).

²¹⁴ A formula may be used as the manner and basis of the conversion of the interests.

²¹⁵ BUS. ORGS. § 10.103(c).

²¹⁶ *Id.* at (a)(6).

²¹⁷ *Id.* § 10.106.

²¹⁸ *Id.* § 10.107.

profit corporation is prohibited from converting into a for-profit entity.²¹⁹

After approval of a plan of conversion, a certificate of conversion must be filed for the conversion to become effective if any domestic entity that is a party to the conversion is a filing entity or any domestic entity to be created under the plan of conversion is a filing entity.²²⁰ The certificate of conversion must include either the plan of conversion or alternative required statements. The alternative required statements must include that a signed plan of conversion is on file at the principal place of business of the converting entity and will be on file after the conversion at the principal place of business of the converted entity and, in each case, the address of the principal place of business, and that a copy of the plan of conversion will be on written request furnished without cost by the converting entity before the conversion, or by the converted entity after the conversion, to any owner or member of the converting entity or the converted entity. The certificate of conversion must also state that the plan of conversion has been approved as required by the laws of the jurisdiction of formation and the governing documents of the converting entity.²²¹

Section 10.1025 authorizes a converting entity to elect to continue its existence in its current organizational form and jurisdiction of formation in connection with a conversion under Chapter 10 of the Code. This election is only available to a domestic entity of one organizational form that is converting into a non-United States entity of the same organizational form or to a non-United States entity of one organizational form converting into a domestic entity of the same organizational form. The election must be adopted and approved as part of the plan of conversion for the converting entity and permitted by, or not prohibited by or inconsistent with, the laws of the applicable non-United States jurisdiction. Because the converting entity continues to exist both in the non-United States jurisdiction and in Texas, Chapter 9 of the Code, relating to registration of foreign filing entities to do business in Texas would not apply to the entity after its conversion and continuance.²²²

Because a conversion of ownership or membership interests is not required in such a conversion and continuance transaction, a description of such conversion is not necessary in the plan of conversion.²²³ Additionally, a statement must be included in the plan of conversion to the effect that the converting entity is electing to continue its existence in its current organizational form and jurisdiction of formation after the conversion becomes effective. The effects of a conversion and continuance transaction are that the converting entity continues to exist both in its current organizational form and jurisdiction of formation and in the same organizational form in the new jurisdiction of formation, as a single entity subject to the laws of both jurisdictions. The property interests, liabilities and obligations of the entity remain unchanged.²²⁴ The certificate of conversion must be titled a “certificate of conversion and continuance” and must include a statement certifying that the converting entity is electing to

²¹⁹ *Id.* § 10.108.

²²⁰ *Id.* § 10.154(a).

²²¹ *Id.* § 10.154.

²²² *See id.* §§ 9.001, 1.002(28).

²²³ *Id.* § 10.103(a).

²²⁴ *Id.* § 10.109.

continue its existence in its current organizational form and jurisdiction of formation.²²⁵

C. Interest Exchanges. The Code also permits domestic entities and non-Code organizations to adopt a plan of exchange pursuant to which the entities would effect an “*interest exchange*” in which all of the outstanding ownership or membership interests in one or more classes or series of one or more domestic entities are acquired.²²⁶ If a non-Code organization is to acquire ownership or membership interests in the exchange, the non-Code organization must take all action that is required under the laws of the organization’s jurisdiction of formation and the organization’s governing documents to effect the exchange. The issuance of the ownership or membership interests in any non-Code organization must also be permitted by the laws under which the non-Code organization is incorporated or organized and not inconsistent with those laws. A plan of exchange may not be effected if an owner or a member of a domestic entity that is a party to the interest exchange will, as a result of the exchange, become subject to owner liability, without the consent of the owner or member, for the liabilities or obligations of any other person or organization.²²⁷

The plan of exchange must be in writing (though it need not be signed) and must include the manner and basis of exchanging the ownership or membership interests to be acquired²²⁸ for (A) ownership or membership interests, obligations, rights to purchase securities, or other securities of one or more of the acquiring organizations is a party to the plan of exchange; (B) cash; (C) other property, including ownership or membership interests, obligations, rights to purchase securities, or other securities of any other person or entity; or (D) any combination of those items. The manner and basis of exchanging an ownership or membership interest of an owner or member that is exchanged in a manner or basis different from any other owner or member having ownership or membership interests of the same class or series must be included in the plan of exchange.²²⁹ Any of the terms of the plan of exchange may be made dependent on facts ascertainable outside the plan if the manner in which those facts operate on the terms of the interest exchange is clearly and expressly stated in the plan.²³⁰

If a domestic partnership (including a limited partnership) is a party to the interest exchange and its partnership interests are to be acquired, the domestic partnership must approve the plan of exchange in the manner provided by its partnership agreement, and the partnership agreement of such domestic partnership must authorize the partnership interest exchange adopted by the partnership. “Each acquiring domestic partnership must take all actions that may be required by its partnership agreement in order to effect the exchange.”²³¹

²²⁵ *Id.* § 10.154(c).

²²⁶ *Id.* §§ 10.051–10.056.

²²⁷ *Id.* §§ 10.051, 1.002(63-a).

²²⁸ A formula may be used as the manner and basis of the exchange of the interests.

²²⁹ BUS. ORGS. § 10.052.

²³⁰ *Id.* at (c).

²³¹ *Id.* § 10.056.

Upon effectiveness of an interest exchange, the ownership or membership interest of each acquired organization is exchanged as provided in the plan of exchange, and the former owners or members whose interests are exchanged under the plan of exchange are entitled only to the rights provided in the plan of exchange or, if dissenters' rights are applicable, a right to receive the fair value of the ownership interests. Additionally, the acquiring organization has all rights, title and interests with respect to the ownership or membership interest to be acquired by it subject to the provisions of the plan of exchange.²³²

The provisions relating to filing of a certificate of exchange are generally parallel to those for filing a certificate of merger under the Code.²³³

D. Sales of Assets. For property transfers and dispositions, the Code contains broad enabling provisions that authorize a domestic entity to sell, lease, assign or otherwise transfer or convey an interest in its property, including real property.²³⁴ The transfer and conveyance may be made with or without the goodwill of the entity on any terms and conditions and for any consideration and may be made by a deed with or without the seal of the entity. Similarly, a domestic entity may grant a pledge, mortgage or deed of trust with respect to an interest in its property including real property with or without the seal of the entity.²³⁵ No approval of the owners or members of the entity is required except as otherwise provided in the Code, governing documents of the domestic entity or specific limitations established by its governing authority.²³⁶

The Code specifically provides that a disposition of all or part of the property of a domestic entity, regardless of whether the disposition requires the approval of the entity's owners or members, is not a merger or conversion for any purpose. Except as otherwise expressly provided by another statute, a person acquiring property may not be held responsible or liable for a liability or obligation of the transferring domestic entity that is not expressly assumed by the person.²³⁷

The requirements for approval by owners or members of sales of all or substantially all of the assets of the entity have been retained in the Code, where applicable, in the Titles governing the separate types of entities. Thus, for example, the requirement that the shareholders approve the sale of all or substantially all of the assets of a for-profit corporation is contained in Section 21.455 of the Code.²³⁸

E. Franchise Taxes. A common problem to avoid in filing of the certificate of merger, conversion or exchange is the failure to provide a certificate from the Texas Comptroller evidencing the good standing for payment of Texas franchise taxes of the domestic entities

²³² *Id.* § 10.055.

²³³ *Id.* §§ 10.151, 10.153.

²³⁴ Sections 101.605 and 101.609(c) of the Code also express the authority of a series of a limited liability company to, among other things, sell, lease and convey the property of the series.

²³⁵ BUS. ORGS. § 10.251.

²³⁶ *Id.* § 10.252.

²³⁷ *Id.* § 10.254.

²³⁸ *Id.* § 21.455.

involved in the merger, conversion or interest exchange.²³⁹ Alternatively, a statement can be set forth in the certificate of merger, conversion or exchange that one or more of the surviving new or acquiring organizations or the converted entity is liable for the payment of the required franchise taxes.²⁴⁰

F. Approval Procedures. The procedures for approval of fundamental business transactions by the governing authority, owners or members of domestic entities are generally located in the separate titles governing those types of entities as well as Chapter 6 Meetings and Voting.²⁴¹ The primary exception to this rule is the provisions contained in Chapter 10 governing the approvals by partnerships of fundamental business transactions.²⁴²

G. Abandonment. A merger, interest exchange or conversion can be abandoned by any of the domestic parties that are party to the merger, interest exchange or conversion under the procedures provided by the plan of merger, exchange or conversion or, if no abandonment procedures are provided, in the manner determined by the governing authority. Such abandonment can occur before the filing of the certificate of merger, exchange or conversion and after approval of the merger, interest exchange or conversion by the owners or members.²⁴³ Additionally, if the certificate of merger, exchange or conversion provides for a delay in effectiveness of the merger, interest exchange, or conversion, the merger, interest exchange or conversion can be abandoned before its effectiveness.²⁴⁴

H. Dissenters' Rights. Shareholders of domestic for-profit corporations, domestic professional corporations, domestic professional associations and domestic real estate investment trusts have dissenters' rights under the Code regarding certain transactions.²⁴⁵ While the Code does not expand the provisions for dissenters' rights beyond the types of entities that had such provisions under the prior statutes, the Code does permit partnerships and limited liability companies to adopt its provisions for dissenters' rights in their governing documents.²⁴⁶ The following is a summary of various provisions of the Code regarding dissenters' rights up to the appraisal proceedings before a court.²⁴⁷ The summary assumes that the entity taking an action giving rise to dissenters' rights is a for-profit corporation, that the dissenting owner is a shareholder and that the ownership interests as to which the dissenters' rights are exercisable are shares.

A shareholder is granted dissenters' rights under Section 10.354 in connection with (1) any fundamental business transaction on which such shareholder is entitled to vote, (2) any

²³⁹ *Id.* § 10.156(2).

²⁴⁰ *Id.*

²⁴¹ *See, e.g., id.* §§ 21.452–21.455.

²⁴² *See id.* §§ 10.009, 10.056, 10.108.

²⁴³ *Id.* § 10.201.

²⁴⁴ *Id.* § 10.202.

²⁴⁵ *Id.* §§ 10.351(b), 21.460, 303.001, 302.001, 200.410.

²⁴⁶ *Id.* § 10.351(c).

²⁴⁷ We focus on the provisions regarding dissenters' rights up to the appraisal proceeding because it is those provisions which were amended in 2015 and in the preceding few Texas legislative sessions and because there is a good summary of the provisions of the Code and the case law, and certain unanswered questions, regarding appraisal proceedings in Miller & Ragazzo, 20A *Texas Practice: Business Organizations* (3d ed.) §§ 40.15–.17.

plan of exchange under which such shareholder's shares are to be acquired, (3) any short-form merger in which such shareholder's shares are to be converted or exchanged and (4) (because of the 2015 amendments to the Code) any back-end merger under Section 21.469(c) in which such shareholder's shares are converted or exchanged.²⁴⁸ However, dissenters' rights do not apply to a plan of merger (if there is only one surviving entity or non-code organization) or a plan of conversion or exchange if (1) the shareholder's shares before the transaction are of a class or series of shares that are listed on a national securities exchange or held of record by at least 2,000 persons, (2) the shareholder is not required to accept any consideration different from the consideration provided to other holders of shares of the same class or series and (3) the shareholder is not required to accept any consideration other than shares or ownership interests of a class or series that will be listed or authorized for listing on a national securities exchange or held of record by at least 2,000 holders, or cash in lieu of fractional shares or ownership interests. This exception, however, does not apply to a shareholder of a subsidiary involved in a short-form merger or, because of the 2015 amendments to the Code, any back-end merger under Section 21.469(c).²⁴⁹

For any action (i.e., a fundamental business transaction) subject to dissenters' rights, (1) the corporation or other entity responsible for notices and payment of value upon exercise of dissenters' rights (the "responsible organization") must give notice of dissenters' rights to each shareholder having such right either with the notice of the shareholders' meeting, if such a meeting is to be held,²⁵⁰ or with the request for such shareholder's written consent, if the shareholders are to act by written consent;²⁵¹ (2) in connection with a short-form merger, the responsible organization must give notice of dissenters' rights to the domestic subsidiary's shareholders no later than 10 days after the merger is effective,²⁵² and (3) in connection with a back-end merger, the responsible organization must give notice of dissenters' rights to the shareholders who have such rights no later than 10 days after the merger is effective.²⁵³ In any case, the notice must include a copy of subchapter H of Chapter 10 of the Code (Rights of Dissenting Owners) and the address of the responsible organization's principal executive offices to which the shareholder may send a notice or demand to exercise his dissenters' rights.²⁵⁴ Under the 2015 amendments to the Code, in the case of a back-end merger under Section 21.469(c), the notice of dissenters' rights may be given at any time before or within 10 days after the effectiveness of the merger, and it is typical practice for such a notice to be given before the effectiveness of the merger, when the target responds to the tender or exchange offer as required under the federal securities laws. If the notice is given before the consummation of the tender or exchange offer, it must be given to each shareholder to whom the tender or exchange offer is made; but if the notice is given after the consummation of the tender or exchange offer (which must be not long before the effectiveness of the merger), it must be given to each shareholder who did not tender shares in such offer.²⁵⁵ If the notice is given

²⁴⁸ BUS. ORGS. §§ 10.354(a), 21.469(c).

²⁴⁹ *Id.* § 10.354(b)–(c).

²⁵⁰ *Id.* § 10.355(a)(1), (d)(1).

²⁵¹ *Id.* at (a)(2) and (d)(2).

²⁵² *Id.* at (b).

²⁵³ *Id.* at (b-1).

²⁵⁴ *Id.* at (c).

²⁵⁵ *Id.* at (d)(3).

before the effective date of the merger, then unless the notice contains a statement of 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. If the notice is given on or after the effective date of the merger, it must include a statement of the effective date of the merger.²⁵⁶

With respect to any action submitted to a vote at a shareholders' meeting, the responsible organization must also give a notice that the action has become effective to each shareholder who sent notice of his intent to exercise his dissenters' rights and who voted against the action at the meeting. Such notice must be given no later than the 10th day after the action becomes effective.²⁵⁷ With respect to any action approved by a written shareholders' consent, the responsible organization must also give a notice that the action has become effective to each shareholder whose written consent was not given or requested and who therefore did not receive the requisite notice when his written consent was requested. Such notice must be given no later than the 10th day after the action becomes effective.²⁵⁸

To exercise or "*perfect*" dissenters' rights, a shareholder must take certain actions specified by Section 21.356; a shareholder will lose his rights if there is any failure to comply. In general, the required actions to perfect dissenters' rights are as follows:

If the proposed action (i.e., a fundamental business transaction) is to be voted on at a shareholders' meeting, the shareholder must give the responsible organization a notice, before the meeting, indicating his intent to exercise his dissenters' rights,²⁵⁹

The shareholder must either vote against the action at the meeting or must not execute a shareholder's written consent in favor of the action,²⁶⁰

Within 20 days after the responsible organization's notice to the shareholder that the action has become effective, the shareholder must give the responsible organization a written demand for payment of the fair value of his shares.²⁶¹ In accordance with the 2015 amendments to the Code, however, in the case of a back-end merger under Section 21.459(c), the shareholder must make demand within either 20 days after the responsible organization gives the initial required notice of dissenters' rights or the date on which the tender or exchange offer is consummated, whichever is later,²⁶²

Within 20 days after the shareholder makes a demand for payment of fair value, he must submit to the responsible organization any stock certificates representing his shares as to which he is demanding payment, so that notation may be made on the certificate that payment has been demanded.²⁶³ A shareholder who has made demand for payment of the fair value of his

²⁵⁶ *Id.* at (f).

²⁵⁷ *Id.* at (e).

²⁵⁸ *Id.* at (d)(2).

²⁵⁹ *Id.* § 10.356(b)(1).

²⁶⁰ *Id.* at (b)(2).

²⁶¹ *Id.* at (b)(3).

²⁶² *Id.* at (b)(3)(E)(iv).

²⁶³ *Id.* § 10.356(d).

shares may withdraw such demand at any time before payment is made for such shares or a petition is filed and thereafter only with the consent of the responsible organization.²⁶⁴

Within 20 days after the responsible organization receives the demand, it must respond in writing to accept or reject the value or price demanded. If the responsible organization accepts the demand, it must pay the amount, in exchange for delivery of the shares, within 90 days after the action that is the subject of the demand (i.e., the fundamental business transaction) became effective.²⁶⁵ If the responsible organization rejects the value or price demanded, it must provide to the dissenting shareholder its estimate of the fair value of the shares and offer to pay such amount.²⁶⁶ If the dissenting shareholder accepts the offer, he must give notice of acceptance to the responsible organization within 90 days after the action that is the subject of the demand became effective.²⁶⁷ Upon such agreement between the dissenting shareholder and the responsible organization, or if the dissenting shareholder and the responsible organization otherwise agree on the fair value of the shares, then the responsible organization must pay the agreed amount, in exchange for delivery of the shares, within 120 days after the action that is the subject of the demand became effective.²⁶⁸

If the responsible organization and the dissenting shareholder are unable to reach agreement within the period described in the preceding paragraph, then either party may file a petition to have a court determine the fair value of the shares.²⁶⁹ The petition must be filed, within 60 days after the expiration of the period for considering the responsible organization's offer of fair value, in a court in the county of Texas in which the responsible organization's principal office is located or, if the responsible organization has no business office in Texas, in the county in which the responsible organization's registered office in Texas is located.²⁷⁰ If the responsible organization files the petition, the petition must be accompanied by a list of the names and addresses of the shareholders who have demanded appraisal and who have not agreed on the value or price of the shares. If the dissenting shareholder files the petition, the responsible organization must file such a list with the clerk of the court within 10 days after the responsible organization is served with the petition, and the clerk must subsequently send a notice of the time and place of the appraisal hearing to each dissenting shareholder.²⁷¹ If the record or registered holder of the shares is the trustee of a voting trust or the nominee holder of the shares for a beneficial holder and has perfected the dissenters' rights, such beneficial owner may file the petition and participate in the appraisal proceedings without the need for the record or registered holder to be the plaintiff or to participate in the appraisal proceedings.²⁷²

In the appraisal proceeding, the court must determine the "fair value" of the shares as of the date preceding the date of the action that is the subject of the appraisal, specifically

²⁶⁴ *Id.* § 10.357.

²⁶⁵ *Id.* § 10.358(a)(1), (b).

²⁶⁶ *Id.* at (a)(2) and (c).

²⁶⁷ *Id.* at (d).

²⁶⁸ *Id.* at (e).

²⁶⁹ *Id.* § 10.361(a).

²⁷⁰ *Id.* at (a) and (b).

²⁷¹ *Id.* at (c) and (d).

²⁷² *Id.* at (g).

excluding any appreciation and depreciation in value because of anticipation of such action or the result of such action,²⁷³ and must appoint one or more qualified appraisers to determine the fair value.²⁷⁴

XIV. MISCELLANEOUS PROVISIONS IN OTHER CHAPTERS IN TITLE 1

A. Chapter 3 Formation and Governance. Chapter 3 of the Code contains several provisions that will apply to domestic entities engaged in fundamental business transactions. Section 3.005 specifies the requirements for the certificate of formation that must be filed with the filing officer in order to form a domestic filing entity.²⁷⁵ One of the provisions in that Section states that a filing entity formed under a plan of conversion or merger need not state the name and address of its organizer, but must state that it was formed under a plan of merger or conversion.²⁷⁶ If formed under a plan of conversion, the certificate of formation must state the name, address, date of formation, prior form of organization and jurisdiction of formation of the converting entity.²⁷⁷ In addition, the certificate of formation of the domestic filing entity must be filed with the certificate of conversion or merger.²⁷⁸ The formation and existence of a domestic filing entity that is a converted entity in a conversion or that is created under a plan of merger takes effect and commences on the effectiveness of the conversion or merger.²⁷⁹ For a limited partnership formed pursuant to a merger or a conversion, the plan of merger or conversion may include the partnership agreement for the limited partnership.²⁸⁰

B. Chapter 4 Filings. Chapter 4 of the Code contains the general provisions specifying the requirements for filing instruments to be filed with the Texas Secretary of State. Any certificate of merger, conversion or exchange must meet these requirements before being permitted to be filed. Subchapter D of Chapter 4 imposes filing fees on various filings with the Texas Secretary of State.²⁸¹ The filing fee for a certificate of merger or conversion (other than a filing on behalf of a nonprofit corporation) is \$300, plus, with respect to a merger, any fee imposed for filing a certificate of formation for each newly created filing entity or, with respect to a conversion, the fee imposed for filing a certificate of formation for the converted entity.²⁸² For a non-profit corporation, the filing fee for a certificate of merger or a conversion is \$50.²⁸³

C. Chapter 5 Registered Agents. Chapter 5 of the Code contains provisions that require an entity to obtain the prior consent of its registered agent to serve in that capacity for the entity. Section 5.2011 specifies that the designation or appointment of a person as registered

²⁷³ *Id.* § 10.362.

²⁷⁴ *Id.* § 10.361(e).

²⁷⁵ *Id.* § 3.005.

²⁷⁶ *Id.* at (e)(6)–(7).

²⁷⁷ *Id.* at (a)(7).

²⁷⁸ *Id.* § 3.006(a).

²⁷⁹ *Id.* § 3.006.

²⁸⁰ *Id.* § 3.011(b).

²⁸¹ *Id.* §§ 4.151–4.161.

²⁸² *Id.* § 4.151(5).

²⁸³ *Id.* § 4.153(3).

agent by an organizer or managerial official of an entity in a registered agent filing is an affirmation that the person named as registered agent has consented to serve in that capacity.²⁸⁴ This section also specifies that following a sale, acquisition, or transfer of a majority in interest or a majority interest of the outstanding ownership or membership interests of a represented entity, if the registered agent continues to serve in that capacity, the person's continuation of service is an affirmation by the governing authority of the represented entity that the governing authority has verified that the person named as registered agent has consented to continue to serve in that capacity.²⁸⁵ This requirement can be a trap for the unaware in the context of a merger, acquisition or change in control. The consent of a person, whether an individual or organization, to serve as the registered agent of the entity must be set forth in a written or electronic form developed by the Texas Secretary of State's Office, but there is no form specified for the required verification of the registered agent's consent to continue to serve upon the sale, acquisition or transfer of a majority of the outstanding ownership or membership interests.²⁸⁶

D. Chapter 6 Meetings and Voting. Chapter 6 of the Code specifies general rules concerning meetings, voting, actions by written consent, and record dates. Some of these provisions will apply to domestic entities engaged in fundamental business transactions. For example, the general provisions regarding the notice requirements and waiving of notices for a meeting of owners to approve a fundamental business transaction would apply to the meeting in which the fundamental business transaction is to be approved.²⁸⁷ Additionally, the provisions for record dates for establishing owners entitled to vote on the fundamental business transaction or to execute a written consent to approve the fundamental business transaction would also apply.²⁸⁸ Care must be taken that the separate Chapters governing the approval procedures for fundamental business transactions of each different type of entity do not contain additional or conflicting requirements.

E. Chapter 8 Indemnification and Insurance. Chapter 8 of the Code contains provisions relating to certain kinds of domestic entities and organizations, which are referred to in the Chapter as "*enterprises*." The Chapter specifies the requirements and limitations on indemnification of governing persons, officers, and agents of an enterprise. The definition of "*enterprise*" specifically includes any predecessor domestic entity or organization, whether by way of merger, conversion, consolidation or other transaction in which the liabilities of the predecessor enterprise are transferred or allocated to the enterprise by operation of law or by assumption of the liabilities of the predecessor enterprise.²⁸⁹

F. Chapter 9 Foreign Entities. Chapter 9 of the Code contains several provisions that will apply to foreign entities engaged in fundamental business transactions. A foreign filing entity may amend its application for registration to disclose a change that results from a conversion from one type of foreign filing entity to another type of foreign filing entity or a

²⁸⁴ *Id.* § 5.2011(a).

²⁸⁵ *Id.* at (b).

²⁸⁶ *Id.* §§ 5.201(b), 5.2011(b).

²⁸⁷ *See id.* §§ 6.051–6.053.

²⁸⁸ *See id.* §§ 6.101, 6.102.

²⁸⁹ *Id.* § 8.001(2), (7).

2016]

ENTITY ACQUISITIONS UNDER TBOC

129

merger into another foreign filing entity.²⁹⁰ In either case, the foreign filing entity making the amendment succeeds to the registration of the original foreign filing entity.²⁹¹ Section 9.012 eliminates an unnecessary filing instrument in connection with a conversion of a foreign filing entity or foreign limited liability partnership into a domestic filing entity. A formal withdrawal of the registration of the foreign entity no longer needs to be filed because the filing of the certificate of conversion sufficiently indicates the status of the converting foreign entity. The provision also applies to a conversion and continuance transaction under Section 10.1025.²⁹²

As a general rule, if the existence of a foreign filing entity or foreign limited liability partnership registered in Texas terminates because of dissolution, termination, merger, conversion or other circumstances, a certificate by an authorized governmental official of the entity's jurisdiction of formation that evidences the termination must be filed with the Texas Secretary of State.²⁹³

²⁹⁰ *Id.* § 9.009(a-1).

²⁹¹ *Id.*

²⁹² *Id.* § 9.012.

²⁹³ *Id.* § 9.011(d).

CROWDFUNDING AND THE PUBLIC/PRIVATE DIVIDE IN U.S. SECURITIES REGULATION[©]

Joan MacLeod Heminway*

I. INTRODUCTION

The origination and expansion of crowdfunding as a capital-raising tool has been a hot topic on the street and in the media and the academy for a few years now. In less than ten years, this fusion of social media and traditional corporate finance—a mode of corporate finance through which firms raise investment capital by reaching out over the Internet to a broad, undifferentiated mass of potential investors¹—grew from a creative impulse to a movement that catalyzed federal legislative action.² Its socio-legal bounds are as yet relatively untested. It seems that crowdfunding offers something to nearly everyone.

Of course, U.S. securities law has something to say about crowdfunding when the firms using this capital-raising method are participating in an offering of securities.³ Specifically, Section 5 of the Securities Act of 1933, as amended (the 1933 Act),⁴ provides that offers and sales of securities are required to be registered—a process that includes the filing and revising

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** The information provided in this article speaks as of the summer of 2015 and does not take into account the adoption of final agency rules under the CROWDFUND Act, which occurred late in the fall of 2015 and went into effect in May 2016.

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¹ In essence, this is the definition of crowdfunding that I will be working with in this article. Broader definitions of crowdfunding also exist and can be useful in other contexts. *See, e.g.*, THOMAS ELLIOTT YOUNG, THE EVERYTHING GUIDE TO CROWDFUNDING 14 (2013) (“Crowdfunding is the process of soliciting funds from the general public to create projects or fund businesses.”); Thaya Brook Knight et al., *A Very Quiet Revolution: A Primer on Securities Crowdfunding and Title III of the Jobs Act*, 2 MICH. J. PRIV. EQ. & VENTURE CAP. L. 135, 135 (2012) (“At its most basic level, crowdfunding means using a method of mass communication, typically the Internet, to solicit funds from the community at large, with the project creator receiving small individual amounts of funding from a large number of donors or investors.”). This article focuses most directly on crowdfunding that involves the offer and sale of securities, which typically is referred to as securities crowdfunding, investment crowdfunding, or crowdfund investing.

² *See* SHERWOOD NEISS ET AL., CROWDFUND INVESTING FOR DUMMIES 33–38 (2013).

³ *See generally* C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, 2012 COLUM. BUS. L. REV. 1 (2012) (identifying and describing various securities regulation issues relating to securities crowdfunding); Joan MacLeod Heminway & Shelden Ryan Hoffman, *Proceed at Your Peril: Crowdfunding and the Securities Act of 1933*, 78 TENN. L. REV. 879 (2011) (explaining the offering registration issues arising out of securities crowdfunding).

⁴ 15 U.S.C. § 77(e) (2012).

of a disclosure document called a registration statement—unless they comply with an exemption from registration. Crowdfunding efforts sometimes run afoul of the registration requirement, in particular when the financial interests being offered constitute investment contracts rather than equity or debt securities.⁵ Prior to the 2012 adoption of the Jumpstart Our Business Startups Act (the JOBS Act),⁶ registration exemptions for crowd-funded securities offerings were not readily available.⁷ Moreover, at that time, potential securities crowdfunding websites were concerned that they might be required to register as regulated intermediaries under the Securities Exchange Act of 1934, as amended (the 1934 Act).⁸ Crowdfunding advocates became frustrated with the impediment represented by federal securities regulation (in particular, the offering registration requirement) and lobbied for change in the nation's capital.⁹

The resulting federal legislation, the Capital Raising Online While Deterring Fraud and Unethical Non-Disclosure Act (the CROWDFUND Act), Title III of the JOBS Act, adds a new exemption from registration to the 1933 Act. In the process, the CROWDFUND Act also creates a new type of financial intermediary regulated under the 1934 Act¹⁰ and amends the 1934 Act in other ways. Important among these additional changes is a provision exempting holders of securities sold in crowd-funded offerings from the calculation of shareholders that requires securities issuers to become reporting companies under the 1934 Act.¹¹ The registration exemption provided in the CROWDFUND Act is not self-effectuating. Rulemaking by the U.S. Securities and Exchange Commission (the SEC), as well as the Financial Industry Regulatory Authority (the FINRA), is required to implement the exemption. At the time work on this article was completed, these regulatory efforts were in process but not yet completed.

The CROWDFUND Act and the JOBS Act (of which it is a part) cover significant doctrinal ground and include provisions beloved by some and disdained by others. This article focuses narrowly on the CROWDFUND Act as a reaction to two historically significant public/private distinctions in U.S. federal securities law: the line between public offerings and private offerings and the division between public companies and private companies—ways of understanding and categorizing business associations for purposes of U.S. federal securities regulation. The regulatory boundary between public offerings and private placement transactions is a basic building block among the varied legal aspects of corporate finance. Along the same lines, the distinction between public companies and private companies

⁵ See Heminway & Hoffman, *supra* note 3, at 882-86 (explaining that early academic and regulatory interest in crowdfunding stemmed from concern that entrepreneurs were violating the federal securities laws by crowdfunding interests in businesses and projects that constitute securities because they are investment contracts); see also Joan MacLeod Heminway, *What is a Security in the Crowdfunding Era?*, 7 OHIO ST. ENTPREN. BUS. L.J. 335, 360 (2012) (noting that “[t]he use of investment contracts . . . became more prominent in the crowdfunding environment that existed in the year or two before the U.S. federal government began to take an interest in crowdfunding”).

⁶ Pub. L. No. 112-106, §§ 301–305, 126 Stat. 306, 315–321 (2012) (codified in scattered subsections of 15 U.S.C. §§ 77, 78).

⁷ Heminway & Hoffman, *supra* note 3, at 911–21.

⁸ 15 U.S.C. §§ 78a–78oo.

⁹ See NEISS ET AL., *supra* note 2, at 34–38.

¹⁰ See §§ 302, 304, 126 Stat. at 315–21, 321–22 (codified at 15 U.S.C. §§ 77d-1(a), 78c(a)(80)).

¹¹ See *id.* § 303, 126 Stat. at 321 (codified at 15 U.S.C. § 78l(g)).

(together with related concepts like the registration of classes of securities under the 1934 Act and the listing of securities on national securities exchanges) is fundamental to U.S. federal securities regulation, but it also can be significant for reasons that extend well beyond securities regulation. For example, the divide between public and private companies is implicated in other areas of federal regulation¹² and is even incorporated into some state laws.¹³

The very notions of a crowdfunded offering and issuer of securities challenge pre-existing public-private distinctions. The archetypal business or project that desires to engage in crowdfunding—including securities crowdfunding—is intent on seeking business financing in a very unrestricted way: by openly soliciting funds over the Internet from a large, varied group of people. This type of securities transaction looks and feels like a public offering and, until the JOBS Act was signed into law, was regulated as one. Similarly, a crowdfunded issuer of securities is likely to have many holders of financial interests and other constituents to manage and inform. This type of issuer of securities looks and feels like a public company and, depending on the markets in which its securities are offered and sold, its total assets, and the number of equity holders it has, it would have been regulated as a public company before the JOBS Act was signed into law.

Until the JOBS Act became law, the dividing lines between public and private offerings and companies had been well understood—even if somewhat under-studied.¹⁴ Public offerings are those made to investors who do not need the benefits of the regulatory system created in the 1933 Act—investors who can fend for themselves because they are able to independently assess or bear the risk of their transactions.¹⁵ And, as commonly understood, U.S. public companies are those that are required by federal law to publicly disclose information on a regular basis.¹⁶ The nature (form and content) of any public disclosures and process through which they must be made are the subject of pages upon pages of statutory and regulatory provisions.¹⁷ Public issuers typically file these required disclosures with the SEC.¹⁸

¹² See, e.g., 12 U.S.C. § 5221(c)(3) (referring to “common or preferred stock of which is not registered pursuant to the Securities Exchange Act of 1934”); 26 U.S.C. § 162(m)(2) (“For purposes of this subsection, the term ‘publicly held corporation’ means any corporation issuing any class of common equity securities required to be registered under section 12 of the Securities Exchange Act of 1934.”).

¹³ See, e.g., CAL. CORP. CODE § 1501 (West 2016) (referring to “a corporation with an outstanding class of securities registered under Section 12 of the Securities Exchange Act of 1934”); DEL. CODE ANN. tit. 8, § 203(b)(4)(i) (West 2016) (referring to a corporation that “does not have a class of voting stock that is . . . [l]isted on a national securities exchange”); N.Y. BUS. CORP. LAW § 512(b) (McKinney 2016) (referring to “redeemable common shares . . . registered under a statute of the United States such as the Securities Exchange Act of 1934, as amended”).

¹⁴ See generally Donald C. Langevoort & Robert B. Thompson, “Publicness” in *Contemporary Securities Regulation After the JOBS Act*, 101 GEO. L.J. 337, 339 (2013) [hereinafter *JOBS Act*] (asserting that “the public-private divide has long been an entirety under theorized aspect of securities regulation.”).

¹⁵ See *Sec. & Exch. Comm’n v. Ralston Purina Co.*, 346 U.S. 119 (1953).

¹⁶ See *infra* notes 25–27 and accompanying text.

¹⁷ See 15 U.S.C. §§ 78m(a), (e), 78n(a), (e) (2012) (providing for the filing of quarterly and annual reports and proxy, going private, and tender offer statements); see also Joan MacLeod Heminway, *To Be or Not to Be (A Security): Funding for-Profit Social Enterprises*, 25 REGENT U. L. REV. 299, 318–19 (2013) (observing that “public company status under the 1934 Act obligates issuers to periodic and transactional reporting”); Robert B. Thompson, *Corporate Federalism in the Administrative State: The SEC’s Discretion to Move the Line Between the State and Federal Realms of Corporate Governance*, 82 NOTRE DAME L. REV. 1143, 1147 (2007) (noting that the 1934 Act

The JOBS Act has brought new attention to the legal conception of the public offering and the public company as reflected in the 1933 Act and the 1934 Act. By making it easier for firms to engage in public offerings of securities while, at the same time, allowing more issuers (including those engaging in crowdfunded offerings of securities) to avoid public company status, the JOBS Act changes and blurs the lines between public offerings and private offerings and between public companies and private companies. Recent scholarly works—in particular, two coauthored articles by Professors Don Langevoort and Bob Thompson¹⁹ and three articles authored by Professor Hillary Sale²⁰—have begun to explore this indistinct zone at the intersection of public and private and have made significant analytical progress. These works also have given fellow scholars and practitioners much food for thought.

In these discussions, the CROWDFUND Act has thus far had a relatively small, cameo appearance. This article attempts to shed more light on the way in which the CROWDFUND Act, as yet unimplemented (due to a delay in necessary SEC rulemaking), interacts with public offering status under the 1933 Act and public company status under the 1934 Act. Using the analytical framework offered by Professors Langevoort and Thompson, along with insights provided in Professor Sale's work, this article explores in three brief parts how the CROWDFUND Act impacts and is impacted by the public/private divide in U.S. securities regulation. First, Part II summarizes the foundational scholarship of Professors Langevoort, Thompson, and Sale on the public/private divide in U.S. securities regulation. Next, Part III undertakes an analysis of the CROWDFUND Act using key elements from this emergent body of work. Finally, the article concludes in Part IV with both a summary of the analysis of the CROWDFUND Act undertaken in Part III and related broad-based observations about U.S. securities regulation at the public/private divide.

II. THE FACT AND NATURE OF PUBLIC OFFERINGS AND PUBLIC COMPANY STATUS

When securities lawyers describe a public offering of securities under the 1933 Act, they point first to Section 5 of the 1933 Act, which provides in essence that no one can offer or sell securities without registering the transaction under the 1933 Act, absent compliance with an applicable exemption.²¹ Registration involves the creation of a registration statement and filing that registration statement with the SEC.²² The registration statement is a disclosure document

regulates insider trading, proxy solicitations, tender offers, and going-private transactions, usually through disclosure regulation).

¹⁸ See sources cited *supra* note 17.

¹⁹ Robert B. Thompson & Donald C. Langevoort, *Redrawing the Public-Private Boundaries in Entrepreneurial Capital Raising*, 98 CORNELL L. REV. 1573 (2013) [hereinafter *Redrawing*]; Langevoort & Thompson, *JOBS Act*, *supra* note 14.

²⁰ Hillary A. Sale, *J.P. Morgan: An Anatomy of Corporate Publicness*, 79 BROOK. L. REV. 1630 (2014) [hereinafter *Sale, J.P. Morgan*]; Hillary A. Sale, *Public Governance*, 81 GEO. WASH. L. REV. 1012 (2013) [hereinafter *Sale, Governance*]; Hillary A. Sale, *The New "Public" Corporation*, 74 LAW & CONTEMP. PROBS. 137 (2011) [hereinafter *Sale, New Corporation*].

²¹ 15 U.S.C. § 77e (2012).

²² See generally Heminway & Hoffman, *supra* note 3, at 908 (“[A]n issuer must file a registration statement that includes operating and financial disclosures about the issuer, information about the securities being offered and sold, and details about the plan of distribution of those securities.”).

that includes a prospectus used for marketing the offering and subjects the filer, known as an issuer, to (among other obligations and subject to conditions) strict liability for misstatements and misleading omissions of material fact in the registration statement.²³ Commonly used exemptions have included those for private placements and limited offerings (historically, under \$5,000,000 in the aggregate).²⁴

And when securities lawyers talk about a public company, they typically are referring to a firm with a class of equity securities registered under Section 12 of the 1934 Act²⁵ or reporting responsibilities under Section 13 or Section 15(d) of the 1934 Act.²⁶ The CROWDFUND Act uses the latter definition.²⁷ A hallmark of public company status is mandatory disclosure—responsibilities for public periodic disclosure and event-oriented or transaction-based disclosure.²⁸ Since 2002, the public company’s enhanced accountability for public disclosure comes with additional layers of regulation that more pervasively and directly impact firm governance.²⁹

In their 2013 article in the *Cornell Law Review*, Professors Langevoort and Thompson address the public/private divide in and under the 1933 Act.³⁰ They begin with the observation that the primary objective of the 1933 Act is to regulate capital financing transactions (while the primary objective of the 1934 Act is to regulate secondary trading transactions)³¹ and continue by noting two boundaries that are important to the public/private divide under the 1933 Act: registered versus exempt offerings and regulated transactions under the 1933 Act versus regulated firms and transactions under the 1934 Act.³² In this context, the article sets forth four key features of the 1933 Act. These four features are: mandatory disclosure; SEC review; restrictions on sales pressure; and liability.³³ The main body of the article comprises an analysis of three recent securities regulation issues that change or blur the boundary lines between public and private companies: reform efforts under the JOBS Act, reverse mergers, and private investment in public equity (“PIPE”) transactions. Importantly, given the time at which the article was published, it offers only a preliminary assessment of the CROWDFUND Act.

The second of the two articles written by Professors Langevoort and Thompson on the

²³ See generally *id.* (“False and misleading registration statements are actionable under Section 11 of the Securities Act, false and misleading prospectuses or oral communications may result in liability under Section 12(a)(2) of the Securities Act, and fraudulent conduct in connection with the offer and sale of securities may be enforced (at least by the SEC) under Section 17(a) of the Securities Act.”).

²⁴ See *id.* at 911–21.

²⁵ 15 U.S.C. § 78l.

²⁶ *Id.* §§ 78m, 78o(d).

²⁷ Pub. L. No. 112-106, § 302(b), 126 Stat. 306, 321 (2012) (codified at 15 U.S.C. § 77d-1(f)(2)).

²⁸ See Sale, *J.P. Morgan*, *supra* note 20, at 1630 (“[P]ublicly held corporations . . . must file public documents and . . . make public statements on an ongoing basis. These documents and statements, such as earnings calls, press releases, and public announcements, are the stories corporations tell to the world at large.”).

²⁹ See Sale, *Governance*, *supra* note 20, at 1013.

³⁰ See Thompson & Langevoort, *Redrawing*, *supra* note 19, at 1574.

³¹ See *id.* at 1574–75.

³² See *id.* at 1575.

³³ See *id.* at 1578–80.

public/private divide in U.S. securities regulation, also released in 2013, focuses attention on the 1934 Act and, more specifically, “when a private enterprise should be forced to take on public status.”³⁴ Published in the *Georgetown Law Journal*, the article identifies two key dimensions—a broad one and a narrow one—that characterize the regulation of public firms under the 1934 Act.³⁵ The broad dimension consists of three values imposed on powerful institutions through the 1934 Act: “transparency, accountability, and openness.”³⁶ The narrow dimension hones in on the manifestation of those values in rules imposed by the securities regulation framework on certain issuers of securities.³⁷ The article concentrates on exploring the latter dimension.³⁸

In this second Langevoort/Thompson collaboration, the coauthors observe that the narrow dimension of publicness is deeply and directly connected to the broader values associated with publicness.³⁹ From this observation, they intuit two key “breakpoints” in the 1934 Act: “the threshold point at which companies must undertake basic public disclosure obligations”⁴⁰ and “the extent to which Congress has articulated public company responsibility and accountability with the implicit image of the large issuer in mind.”⁴¹ The article explores these two breakpoints and concludes by offering the coauthors’ reflections on the informal, reactive regulatory process that governs the actions of securities issuers, intermediaries, and investors in the United States and the way in which technological innovations in securities trading relate to that process.

Professor Sale’s articles on publicness are synchronistic with those of Professors Langevoort and Thompson, and they cite to her ideas and her scholarship in both of their articles. Her work extends beyond the legal requirements associated with the public nature of firms and into the realm of public beliefs about and reactions to that public nature. Specifically, in her first two articles, published in 2011 in *Law and Contemporary Problems* and 2013 in the *George Washington Law Review*, she exposes and examines the relationship between a firm’s public nature and its governance.⁴²

Publicness is both a process and an outcome. When corporate actors lose sight of the fact that the companies they run and decisions they make impact society more generally, and not just shareholders, they are subjected to publicness. Outside actors like the media, bloggers, and Congress demand reform and become involved in the debate. Decisions about governance move from Wall Street to Main Street.⁴³

In her recent *Brooklyn Law Review* article, Professor Sale uses J.P. Morgan Chase & Co.’s

³⁴ See Langevoort & Thompson, *JOBS Act*, *supra* note 19, at 338.

³⁵ See *id.* at 340–41.

³⁶ See *id.* at 340.

³⁷ See *id.* at 340–41.

³⁸ See *id.* at 340.

³⁹ See *id.* at 341.

⁴⁰ *Id.*

⁴¹ *Id.* at 342.

⁴² See Sale, *Governance*, *supra* note 20, at 137; Sale, *New Corporation*, *supra* note 20, at 1013.

⁴³ Sale, *New Corporation*, *supra* note 20, at 1013.

reaction to the London Whale incident as case study that illustrates how the public nature of a firm both drives firm behavior and reflects the consequences of that behavior.⁴⁴

Professor Sale's two-way relationship between publicness and governance has an ascertainable, if not definitive, flow.

Corporations make choices Once corporations communicate these choices to the world, the public develops an understanding of how the corporations have chosen to delegate power and responsibilities, as well as about where the gaps and weaknesses in governance might be. When public actors outside of the corporation reframe and retell the stories, those actors come to play a role in the corporation. Arguably, these outside actors can even become part of the governance rubric, creating pressure for changes in the decision-making structure or the allocation of power within the corporation.⁴⁵

This theory of publicness is a dynamic, progressive, iterative one. Publicness leads to more publicness, which leads to more publicness, and so on.

This body of work produced by Professors Langevoort, Thompson, and Sale provides important touchstones for the analysis of a—if not *the*—critical, lynchpin dichotomy in modern U.S. securities regulation: the line between public and private. These articles also demonstrate a number of ways in which market behaviors and regulation have become co-dependent and otherwise intertwined in ways that may not consciously reflect—or provide outcomes consistent with—articulated policy objectives. Additional work needs to be done to further illuminate these themes. As the most recent addition to the regulatory arsenal that operates at the public/private divide, the CROWDFUND Act provides a logical exemplar for further analysis using the framework established by Professors Langevoort and Thompson and the theoretical and practical reflections provided by Professor Sale.

III. THE CROWDFUND ACT AND PUBLIC OFFERING AND PUBLIC COMPANY STATUS

The public/private divide under the 1933 Act and the 1934 Act is the very genesis of the CROWDFUND Act. Proponents of securities crowdfunding pressed for adoption of the CROWDFUND Act as a direct response to the regulation of public offerings and public companies.⁴⁶ Prior to the CROWDFUND Act, securities crowdfunding was a non-exempt public offering of securities under the 1933 Act;⁴⁷ investors in the amorphous, disaggregated, diverse crowd could not necessarily fend for themselves, and no limited offering exemption

⁴⁴ See Sale, *J.P. Morgan*, *supra* note 20, at 1636 (“[T]he Company’s handling of the Whale losses and ensuing events were not only caused by publicness but also resulted in publicness.”).

⁴⁵ *Id.* at 1632.

⁴⁶ See NEISS ET AL., *supra* note 2, at 34–37 (generally noting securities crowdfunding issues under the 1933 Act and the 1934 Act and describing the ways in which the Startup Exemption Regulatory Framework addressed those issues).

⁴⁷ See Heminway & Hoffman, *supra* note 3, at 912.

from 1933 Act registration was available.⁴⁸ Once an issuer files a registration statement under the 1933 Act, the provisions of Section 15(d) of the 1934 Act make that issuer a public company by requiring the issuer to become a 1934 Act reporting company, at least temporarily.⁴⁹ Moreover, registered or unregistered crowdfunded offerings of equity securities could result in the issuer of the securities becoming a public company under Section 12(g) of the 1934 Act, which then (prior to the CROWDFUND Act) provided for the mandatory registration of a class of equity securities held by at least 500 people if the issuer had at least \$10,000,000 in total assets.⁵⁰ In these ways, before the CROWDFUND Act was passed and signed into law in April 2012, crowdfunded offerings of securities implicated both public offering status and public company status under the 1933 Act and the 1934 Act.

As a result, in response to public outcry, extensive lobbying efforts, and a perceived political need for the U.S. Congress to do something—anything—bipartisan in nature to better serve small businesses in the lingering shadows of the recent global financial crisis (especially something promoted as a potential means of helping rescue what then was a somewhat stagnant economy), the CROWDFUND Act addressed both the public offering and public company issues raised by crowdfunded offerings of securities. Specifically, the CROWDFUND Act added a new transactional exemption from registration under the 1933 Act⁵¹ and exempted securities sold in crowdfunded securities offerings from the 500-shareholder threshold (which itself was amended in another part of the JOBS Act) that triggered public company status under the 1934 Act.⁵² It is these amendments to the 1933 Act and the 1934 Act that bear scrutiny as regulation at the public/private divide in U.S. securities regulation.

A. The CROWDFUND Act and Public Offering Status under the 1933 Act

In addressing the new 1933 Act registration exemption adopted in the CROWDFUND Act as a matter important to the public/private divide, Professors Langevoort and Thompson relate a brief history of the adoption of the CROWDFUND Act as part of the JOBS Act and make a number of basic salient points with general regard to the four key 1933 Act features they identify in their article (mandatory disclosure, SEC review, restrictions on sales pressure, and liability).

First, regarding the so-called wisdom of crowds: There are actually two ideas at work here, somewhat in tension. One is that exposing an entrepreneur's idea to an open forum allows for communication among interested parties, allowing the crowd's collective reaction to elicit new information - someone with knowledge, for example, sharing that an otherwise exciting vision risks a patent violation. Yet nothing in the legislation insists on any such openness. That is actually a harder issue than it seems

⁴⁸ *Id.* at 912–21 (evaluating the potential use of each private and limited offering exemption for crowdfunded offerings of securities and finding each to be inapplicable).

⁴⁹ *See* 15 U.S.C. § 78o(d) (2012).

⁵⁰ *See id.* § 78l(g)(1); 17 C.F.R. § 240.12g-1 (West 2016).

⁵¹ Pub. L. No. 112-106, § 302(a), 126 Stat. 306, 315 (codified at 15 U.S.C. § 77d(a)(6)).

⁵² *Id.* § 303(a), 126 Stat. at 321 (codified at 15 U.S.C. § 78l(g)(6)).

because the wisdom-of-crowds literature stresses that open communication may also have a downside, introducing the risk of anchoring crowdmembers' beliefs and undermining the averaging effect of many independent beliefs. Suffice it to say that the final compromise version of section 4(a)(6) has none of the mechanisms built in that might make equity crowdfunding resemble the kinds of markets that have emerged in other contexts. Indeed, the final compromise version makes the exemption available to an issuer that uses either a funding portal or a broker-dealer firm to raise the capital. The latter obviously raises a serious sales pressure concern - a marginal issuer can find a marginal broker to do cold-call telephone solicitations and invoke the exemption from mandatory disclosure and state regulation. Obviously, this is far distant from the vision said to justify crowdfunding; those cold calls (or e-mail spam) will be exposed to neither a crowd nor much likelihood of any wisdom.

Finally, note that the JOBS Act contains an interesting reversal of *Gustafson* for cases of crowdfunding fraud or misrepresentation. Liability for material misstatements or omissions in crowdfunding tracks the negligence-based standard of section 12(a)(2), as Congress chose to make it "as if the liability were created under section 12(a)(2)." Liability is shared not just by the issuer but also by directors, partners, and principal executive and financial officers, an extension of liability that can be expected to increase the level of due diligence in these offerings. In this sense, Congress was acting well within the familiar template of securities regulation strategies in response to the sales pressure concerns.⁵³

These observations are helpful and take us part of the way down the road in looking at securities crowdfunding under the CROWDFUND Act as a regulation of publicness.

In the year after Professors Langevoort and Thompson published these observations, the SEC issued its rule-making proposal under the CROWDFUND Act.⁵⁴ Accordingly, we now have additional information to work with in assessing the CROWDFUND Act's effects on the distinction between public and private offerings and forms under the 1933 Act. In light of the release of the SEC's rule-making proposal, how does the regulation of offerings under the CROWDFUND Act map to the four features of the 1933 Act identified by Professors Langevoort and Thompson?

1. *Mandatory Disclosure*

The U.S. Congress expressly provided for mandatory disclosure, the first of the four features recognized by Professors Langevoort and Thompson,⁵⁵ under the CROWDFUND

⁵³ Thompson & Langevoort, *Redrawing*, *supra* note 19, at 1606–08 (footnotes omitted).

⁵⁴ Crowdfunding, SEC Release Nos. 33-9470; 34-70741, 78 Fed. Reg. 66428 (proposed Nov. 5, 2013), <http://www.gpo.gov/fdsys/pkg/FR-2013-11-05/pdf/2013-25355.pdf>.

⁵⁵ See Thompson & Langevoort, *Redrawing*, *supra* note 19, at 1579 (noting the required "creation of a registration statement, a public disclosure document that reveals a great deal of information about the issuer and its capital-raising plans.").

Act.⁵⁶ The disclosure obligations come in two types: disclosures made at the time of the offering and those required on an annual basis after completion of the offering.⁵⁷ The SEC's rulemaking proposal carries this scheme forward by providing for specific line-item disclosure requirements founded on familiar concepts in existing mandatory disclosure rules.⁵⁸ These disclosures are proposed to be made on Form C. The proposed SEC rules also call for the use of specially designated variants of the form for amendments, progress updates, annual reporting, and termination of reporting, all as set forth in the proposal release.⁵⁹

The mandatory disclosure provisions of the CROWDFUND Act and the SEC's rulemaking proposal for implementing them acknowledge and confirm a type of relationship that pre-existed the CROWDFUND Act: the relationship between the registration requirements of Section 5 of the 1933 Act and the continuing public reporting obligations imposed on issuers based on those registration requirements through the operation of Section 15(d) of the 1934 Act. However, the CROWDFUND Act treats these mandatory disclosure obligations all as part of a unified continuing whole—part of the bargain of raising capital through crowdfunding—rather than addressing ongoing periodic disclosure following the offering as a separate, temporary requirement based on unique criteria. In other words, the CROWDFUND Act merges offering status and company status in a novel way.⁶⁰

Yet, crowdfunded offerings exempt from registration under the CROWDFUND Act are not registered public offerings, and the periodic reporting required of the issuers engaged in those offerings, as currently proposed, is not the equivalent of that required for public companies.⁶¹ The level of disclosure under the proposed rules is significantly lower in each case (at the time of the offering and as a matter of periodic reporting), and most of the additional responsibilities of public company status—apart from a scaled-down version of mandatory reporting—do not apply to (and are not imposed by the CROWDFUND Act on) crowdfunding issuers. Although Regulation A had earlier blurred the line between public and private offerings for mandatory disclosure under the 1933 Act by requiring limited offering disclosures structured to look like the disclosures used in registered public offerings⁶² and Regulation D requires disclosures for certain registration exemptions,⁶³ the CROWDFUND Act, as implemented through the SEC rules as currently proposed, appears to create an integrated offering and issuer status somewhere between public and private by combining concepts from each regime. Only with final SEC rulemaking will we be able to fully assess exactly where the mandatory disclosure obligations for crowdfunded offerings are situated on

⁵⁶ § 302(b), 126 Stat. at 315–20 (codified at 15 U.S.C. § 77d-1(b)(1), (4)).

⁵⁷ *Id.*

⁵⁸ Crowdfunding, 78 Fed. Reg. at 66437–52.

⁵⁹ *Id.* at 66452–54.

⁶⁰ Professors Thompson and Langevoort note and comment on the trend toward integration of the disclosures compelled by the 1933 Act and the 1934 Act. *See* Thompson & Langevoort, *Redrawing*, *supra* note 19, at 1581–83.

⁶¹ *Compare* Crowdfunding, 78 Fed. Reg. at 66554 (providing, in proposed Rule 202 of Regulation Crowdfunding, the proposed annual reporting requirements under the CROWDFUND Act), *with* U.S. Sec. & Exch. Comm'n, Form 10-K Annual Report Pursuant to Section 13 or 15(d) of The Securities Exchange Act of 1934, <https://www.sec.gov/about/forms/form10-k.pdf> (providing, in Form 10-K under the 1934 act, the annual reporting requirements for U.S. public company issuers).

⁶² 17 C.F.R. §§ 230.252–253 (West 2016).

⁶³ *Id.* §§ 230.502(b)(1), 230.505(b)(1), 230.506(b)(1).

the public-private continuum.

2. SEC Review

The second feature of the 1933 Act identified by Langevoort and Thompson is SEC review—pre-review of an issuer’s disclosure documents as a condition to the issuer’s ability to legally conduct a securities offering. They note that the 1933 Act “provides for review of the registration statement by the SEC staff to ensure its quality and completeness. This review is . . . powerful . . . because the issuer cannot lawfully sell its securities until the registration statement becomes ‘effective,’ the timing of which is largely under bureaucratic control.”⁶⁴ This control may prevent issuers from being able to take advantage of market windows, but it also slows the pace of offerings that may be moving at an unwarranted and unwise speed. As such, the review requirement may act as a circuit breaker of sorts in preventing the damage to investors and the market that fraudulent and other injurious offerings may cause.

Neither Congress nor the SEC provided for pre-offering review of the offering disclosures mandated under the CROWDFUND Act. This is where the observations made by Professors Langevoort and Thompson about crowd wisdom⁶⁵ become important. A principal commentator in this area has posited that the wisdom of the crowd depends on engaging participants with diverse ideas who think independently and make decisions in a decentralized environment featuring effective information aggregators.⁶⁶ If crowd wisdom is to limit the need for either mandatory disclosure or SEC review, then Congress, the SEC, and market participants should foster these crowd-wisdom attributes in crowdfund investment groups and tailor mandatory disclosure obligations accordingly. Assuming the requisite diversity, independence, and decentralization, the SEC’s proposed rules under the CROWDFUND Act require that investors in crowdfunded offerings conducted under the exemption be permitted to cancel their investment commitments until 48 hours prior to the termination of the offering (as established by the issuer in its offering materials), which may afford time for a diverse, independent, decentralized group of crowdfunding investors to act with collective wisdom.⁶⁷ Nevertheless, given the constraints placed by Congress on CROWDFUND Act offerings, the cautionary tale told by Professors Langevoort and Thompson has validity and significant traction.

The SEC noted in its rulemaking proposal that it does intend to use the filings on Form C to monitor issuer compliance and regulatory efficacy.⁶⁸ But *ex post* data gathering and analysis is a far cry from pre-offering reviews of mandatory disclosures, even if those reviews

⁶⁴ Thompson & Langevoort, *Redrawing*, *supra* note 19, at 1579 (footnotes omitted).

⁶⁵ See *supra* note 53 and accompanying text.

⁶⁶ See JAMES SUROWIECKI, *THE WISDOM OF CROWDS* xviii, 23–83 (2005). For a more detailed analysis of the interaction between Surowiecki’s work and crowdfunded securities offerings under the CROWDFUND Act, see Joan MacLeod Heminway, *Investor and Market Protection in the Crowdfunding Era: Disclosing to and for the “Crowd”*, 38 VT. L. REV. 827 (2014).

⁶⁷ Crowdfunding, SEC Release Nos. 33-9470; 34-70741, 78 Fed. Reg. 66428, 66476 (proposed Nov. 5, 2013), <http://www.gpo.gov/fdsys/pkg/FR-2013-11-05/pdf/2013-25355.pdf> (noting that “Under this approach, an investor could reconsider his or her investment decision with the benefit of the views of the crowd and other information, until the final 48 hours of the offering.”).

⁶⁸ See *id.* at 66453.

do not ensure for investors the accuracy or adequacy of the disclosed information. While the assembled data can be analyzed and related studies can be done to improve applicable rules, only *ex ante* examinations of issuer disclosures enable regulators to act as true gatekeepers by most effectively spotting offering defects and delaying or terminating non-compliant or fraudulent offerings.⁶⁹

3. *Restrictions on Sales Pressure*

As a third important feature of the 1933 Act, Professors Langevoort and Thompson point to aspects of the regulatory system for public offerings that help protect investors from marketing and sales tactics that are coercive or unfair.⁷⁰ Intermediation (through underwriters, dealers, and others) is a significant part of the public offering process, and the regulation of intermediaries therefore is important to public offering regulation.

The '33 Act regulates the roles of various intermediaries in the selling process (e.g., underwriters, accountants, and, more indirectly, lawyers), anticipating enhanced due diligence that will protect investors. This marketing restriction is intensely complicated because it tries to balance two inconsistent goals in a very compressed time period: one, allowing the issuer and underwriters on the selling side to build a solid book of committed investors to price the securities accurately and limit the risk associated with the distribution and two, simultaneously giving to the investors on the buying side the practical ability to think through the disclosures (always a work in progress until the effective date) before committing to the deal.⁷¹

The regulation of intermediaries works with what has been an important aspect of issuer regulation instituted in the name of investor protection under the 1933 Act: gunjumping constraints. These statutory rules restrict certain issuer communications in connection with registered public offerings before a registration statement has been filed and in the period between the filing of the registration statement and its effectiveness.⁷² This part of the regulatory system under the 1933 Act is designed to prevent the issuer from priming the market for an upcoming public offering of its securities by engaging in promotional communications outside the SEC-authorized channels. Although these rules have declined in strength (and, therefore, significance) since public offering reforms introduced by the SEC in 2005,⁷³ they remain an important part of the regulation of marketing and sales methods in connection with registered public offerings of securities under the 1933 Act. Because the

⁶⁹ See, e.g., 15 U.S.C. § 77h(b)–(d) (2012) (providing the SEC with the authority to issue refusal orders and stop orders to delay or suspend the effectiveness of a registration statement under the 1933 Act).

⁷⁰ See Thompson & Langevoort, *Redrawing*, *supra* note 19, at 1585–86 (“What makes a public offering special in terms of investor protection is the business-driven need to induce increased demand so as to absorb a large number of shares suddenly coming to market It is the combination of that need and the issuer’s self-interest that justifies the registration requirement.”).

⁷¹ Thompson & Langevoort, *Redrawing*, *supra* note 19, at 1579 (footnote omitted).

⁷² See 15 U.S.C. § 77e(b)(1), (c).

⁷³ For a detailed summary of the ways in which these reforms impacted the gunjumping restrictions under the 1933 Act, see Joseph F. Morrissey, *Rhetoric and Reality: Investor Protection and the Securities Regulation Reform of 2005*, 56 CATH. U. L. REV. 561 (2007).

gunjumping rules constrain offers of securities made without registration or compliance with an applicable exemption, they operate on unregistered crowdfunding offers that fail to comply with the new statutory exemption adopted in the CROWDFUND Act.

The CROWDFUND Act specifically regulates marketing and sales efforts in crowdfunded offerings, but it does so in ways different from the ways in which the 1933 Act and the SEC regulations adopted under it otherwise regulate these activities in connection with public and private offerings of securities. In order to avail themselves of the CROWDFUND Act's exemption from offering registration, issuers must conduct their offerings of securities through a registered intermediary—either a funding portal (a new form of intermediary created in the CROWDFUND Act) or a broker.⁷⁴ An issuer is not permitted to “advertise the terms of the offering, except for notices which direct investors to the funding portal or broker”⁷⁵ and may not

compensate or commit to compensate, directly or indirectly, any person to promote its offerings through communication channels provided by a broker or funding portal, without taking such steps as the Commission shall, by rule, require to ensure that such person clearly discloses the receipt, past or prospective, of such compensation, upon each instance of such promotional communication.⁷⁶

The SEC's proposed rulemaking covers this matter in Rule 205 of Regulation Crowdfunding.⁷⁷ In the proposed rule, after repeating the statutory language, the SEC adds the following: “A founder or an employee of the issuer that engages in promotional activities on behalf of the issuer through the communication channels provided by the intermediary must disclose, with each posting, that he or she is engaging in those activities on behalf of the issuer.”⁷⁸ The proposed SEC rule also prohibits an issuer from directly or indirectly compensating or committing to compensate any person to promote its offerings under the CROWDFUND Act, unless the promotion is limited to notices permitted by, and in compliance with, the advertising restrictions applicable to issuers.⁷⁹ The related text of the release clarifies the transparency rationale underlying these restrictions on compensated promotional activities in the anticipated crowdfunding context.⁸⁰

The marketing efforts of intermediaries also are restricted, to varying degrees. No intermediary may “compensate promoters, finders, or lead generators for providing the broker or funding portal with the personal identifying information of any potential investor.”⁸¹ Registered funding portals are further restricted. The very concept of a funding portal, as defined in the CROWDFUND Act, excludes even ordinary securities offering marketing and

⁷⁴ Pub. L. No. 112-106, § 302(a), 126 Stat. 306, 315 (codified at 15 U.S.C. § 77d(a)(6)(C)).

⁷⁵ *Id.* § 302(b) (codified at 15 U.S.C. § 77d-1(b)(2)).

⁷⁶ *Id.* (codified at 15 U.S.C. § 77d-1(b)(3)).

⁷⁷ Crowdfunding, SEC Release Nos. 33-9470; 34-70741, 78 Fed. Reg. 66428, 66555 (proposed Nov. 5, 2013), <http://www.gpo.gov/fdsys/pkg/FR-2013-11-05/pdf/2013-25355.pdf>.

⁷⁸ *Id.* (Proposed Rule 205(a)).

⁷⁹ *Id.* (Proposed Rule 205(b)).

⁸⁰ *Id.* at 66456.

⁸¹ § 302(b), 126 Stat. at 315 (codified at 15 U.S.C. § 77d-1(a)(10)).

sales support activities offered by other securities transactional intermediaries, since funding portals cannot (among other things):

- (A) offer investment advice or recommendations;
- (B) solicit purchases, sales, or offers to buy the securities offered or displayed on its website or portal;
- (C) compensate employees, agents, or other persons for such solicitation or based on the sale of securities displayed or referenced on its website or portal; [or]
- (D) hold, manage, possess, or otherwise handle investor funds or securities⁸²

Professors Langevoort and Thompson note this differential burden on the two potential qualified intermediaries with disfavor (specifically, as to the ability of registered brokers to engage in promotional activities).⁸³ One might presume that liability considerations (about which more is said in the next subpart of this Part) and adverse reputational effects would constrain overzealous, non-fraudulent marketing and selling efforts undertaken by brokers, but may not be the case.

Overall, the marketing and selling constraints applicable to brokers and funding portals under the CROWDFUND Act are meaningful, but they are somewhat uneven and focused on specific practices that Congress anticipates may provide opportunities for abuse. Moreover, the restrictions imposed on funding portals all but remove any individualized marketing and selling expertise they may have from the offering process, except to the extent that expertise is focused on building an attractive crowdfunding platform that entices investors to come and shop for investment opportunities. Thus, the sell side in an offering conducted under the CROWDFUND Act principally (apart from solicitations made by brokers consistent with their legal and professional obligations) relies on the Internet and the crowd of onlookers, including prospective investors, for its power and would appear to protect investors in a relatively uneven and narrow way. Some issuers may receive more attention than others in the vast, irregular expanse of the Internet. In other words, as a general matter, a CROWDFUND Act offering, viewed through a marketing and sales lens, offers less sell-side (promotional) and buy-side (investor protection) benefit than a registered public offering. It is unclear that investors are adequately or consistently protected from abusive sales practices by the CROWDFUND Act's constrained marketing and sales regime, and that detriment may not be offset by benefits to the overall scheme of capital formation under the CROWDFUND Act.

⁸² *Id.* § 304(b), 126 Stat. at 322 (codified at 15 U.S.C. § 78c(a)(80)). Although the CROWDFUND Act authorized the SEC to suggest additional restrictions on permitted funding portal activities, the SEC declined to exercise that authority. *See* Crowdfunding, 78 Fed. Reg. at 66458.

⁸³ *See* Thompson & Langevoort, *Redrawing*, *supra* note 19, at 1607 (“[A] marginal issuer can find a marginal broker to do cold-call telephone solicitations and invoke the exemption from mandatory disclosure and state regulation.”).

4. *Liability*

Professors Langevoort and Thompson identify the 1933 Act's unique liability features as a critical factor in its regulatory design.

In addition to the SEC's tools to police compliance (e.g., refusals to declare a registration statement effective, stop orders, and enforcement actions), the '33 Act creates three extraordinarily powerful liability standards. Section 11 creates strict liability for the issuer if there are material misstatements or omissions in the registration statement when it becomes effective and due diligence-based liability for other offering participants. Section 12(a)(1) enforces the registration obligation and marketing restrictions, again strictly, against any seller. Section 12(a)(2) extends due diligence-like liability to any material misrepresentations or omissions in any selling efforts connected to the public offering. The public-offering context is well suited to class action treatment, both economically and legally, so that the threat to issuers and other participants in the distribution is particularly potent.⁸⁴

Professors Langevoort and Thompson join others in noting that the strict and due diligence liability provided for in the 1933 Act may serve to compel issuers and intermediaries to be more cautious and careful in their mandatory disclosure in registered public offerings.⁸⁵ Professors Langevoort and Thompson also deliberate the effects of the 1933 Act liability regime on the care that intermediaries take in vetting a registered public offering, offering in this regard that "to the extent that liability . . . forces external due diligence, the selling process is affected If lawyers representing directors, placement agents, and brokers feel pressure to dig more deeply into issuer quality, innocent, careless, or willfully blind misrepresentation by salespeople presumably becomes less likely."⁸⁶

While the CROWDFUND Act does not impose strict liability on crowdfunding issuers for misstatements of material fact or misleading omissions to state material fact, Congress did write into the law a liability provision that is likely to encourage due diligence by the issuer and, potentially, intermediaries.⁸⁷ That liability provision is based on Section 12(a)(2) of the 1933 Act and makes an issuer (and, as applicable, its directors, partners, principal executive officer or officers, principal financial officer, controller or principal accounting officer, and any similarly situated person) liable to a purchaser of its securities for making an untrue statement of a material fact or omitting to state a material fact required to be stated or necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading, as long as (a) the purchaser did not know of the untruth or omission and the (b) issuer does not sustain the burden of proof that it did not know, and in the exercise of reasonable care could not have known, of the untruth or omission.⁸⁸ The statute

⁸⁴ *Id.* at 1580 (footnotes omitted).

⁸⁵ *Id.* at 1582 (citing to "a long-standing concern that the quality of issuer disclosure diminishes under the '34 Act" and attributing this concern to differences in the liability provisions under the 1933 Act and the 1934 Act).

⁸⁶ *Id.* at 1586.

⁸⁷ Crowdfunding, 78 Fed. Reg. at 66537.

⁸⁸ Pub. L. No. 112-106, § 302(b), 126 Stat. 306, 315 (2012) (codified at 15 U.S.C. § 77d-1(c)).

defines issuers broadly—so broadly that the SEC has indicated intermediaries may be liable as issuers under the CROWDFUND Act’s liability provision.

Section 4A(c)(3) defines, for purposes of the liability provisions of Section 4A, an issuer as including “any person who offers or sells the security in such offering.” On the basis of this definition, it appears likely that intermediaries, including funding portals, would be considered issuers for purposes of this liability provision.⁸⁹

The SEC anticipates that intermediaries will perform due diligence procedures to limit their liability risk.⁹⁰ Thus, as Professors Langevoort and Thompson note, Congress invoked standard 1933 Act investor protections by including this misstatements and omissions liability provision in the CROWDFUND Act.⁹¹

This is one area in which the regulation of crowdfunded offerings is treated in a manner substantially similar to the regulation of registered public offerings. Misstatements and omissions liability under the CROWDFUND Act does not include Section 11’s strict liability protections, but it does incorporate a due diligence-like scheme based on Section 12(a)(2). The investor protection objectives of the 1933 Act are well served by these liability provisions in the CROWDFUND Act. In sum, this part of the CROWDFUND Act treats crowdfunded offerings almost as if they were public offerings.

B. The CROWDFUND Act and Public Company Status under the 1934 Act

In addressing publicness under the 1934 Act, Professors Langevoort and Thompson focus their attention on the key rules of the road that connect the central principles undergirding the 1934 Act’s reporting provisions (transparency, accountability, and openness) to business firms that must comply with those provisions. In doing so, they essentially explain what a public company is under the 1934 Act and whether Congress had larger firms in mind when it tinkered with the historical 1934 Act definition of a public company in the JOBS Act. Their explanations, in brief? As to the first matter:

[a] company becomes public for purposes of the 1934 Act by one of three distinct gateways: by making a registered public offering under the 1933 Act (section 15(d) of the 1934 Act); by listing on a national securities exchange (section 12(b)); or simply by having enough record shareholders and total assets (section 12(g)).⁹²

They focus attention on the third of these thresholds. And as to the second matter (whether Congress focused its reform efforts on larger firms), Professors Langevoort and Thompson respond in the affirmative. After asserting that public company status—publicness—under the 1934 Act (and in U.S. federal securities regulation more generally) reflects and incorporates

⁸⁹ Crowdfunding, 78 Fed. Reg. at 66499; *see also* Joan MacLeod Heminway, *The New Intermediary on the Block: Funding Portals under the CROWDFUND Act*, 13 U.C. DAVIS BUS. L.J. 177, 201–04 (2013).

⁹⁰ Crowdfunding, 78 Fed. Reg. at 66499 (suggesting “steps intermediaries could take in exercising reasonable care in light of this liability provision”).

⁹¹ *See* Thompson & Langevoort, *Redrawing*, *supra* note 19, at 1608.

⁹² Langevoort & Thompson, *JOBS Act*, *supra* note 14, at 351.

social, political, and economic interests (as well as the more basic, standard policy objectives of investor protection and capital formation), Professors Langevoort and Thompson express their belief “that nearly all the examples of the melding of investor and broader social interests that have changed the meaning of publicness are reactions to highly salient (usually scandalous) events involving large public companies.”⁹³

The CROWDFUND Act interacts with these observations because it exempts holders of securities acquired in crowdfunded offerings conducted in compliance with the CROWDFUND Act registration exemption under the 1933 Act from the count of record shareholders required for public company status under the 1934 Act. Specifically, the CROWDFUND Act adds a new paragraph to Section 12(g) of the 1934 Act⁹⁴ that requires the SEC to engage in rulemaking to “exempt, conditionally or unconditionally, securities acquired pursuant to an offering made under section 4(6) of the Securities Act of 1933 from the provisions of this subsection.”⁹⁵ The SEC’s proposed rule, Rule 12g–6, provides a permanent exemption from the record holder count under Section 12(g) for holders of equity securities issued in offerings exempt from 1933 Act registration under the CROWDFUND Act.⁹⁶

This proposal delays the more extensive Exchange Act requirements until the issuer either sells securities in a registered transaction or registers a class of securities under the Exchange Act to reach a trading market. This allows an issuer to time the decision to become a reporting company without forcing it to become a reporting company through actions outside of its control (e.g., secondary market trading). By conditioning the more burdensome reporting requirements on the decision to raise new capital or to actively seek a liquid trading market, the benefits of increased disclosure would scale with the scope of investment in the issuer, thus improving efficiency.⁹⁷

Neither the statutory exemption nor the SEC’s related proposed rulemaking directly addresses or apparently supports, in and of itself, transparency, accountability, or openness, the three central 1934 Act regulatory values identified by Professors Langevoort and Thompson.

In their work, Professor’s Langevoort and Thompson expressly decline to analyze the effects of the CROWDFUND Act exemption from Section 12(g) compliance. But they are critical of the JOBS Act’s increase, from 500 to 2000, in the number of shareholders triggering the assumption of public company status under Section 12(g) of the 1934 Act. In that context, they do signal their basic views on this aspect of the CROWDFUND Act in a footnote:

We leave to the side Congress’s . . . innovation . . . that shareholders obtained via the crowd-funding exemption in new section 4(6) of the 1933 Act are not counted for

⁹³ *Id.* at 374.

⁹⁴ 15 U.S.C. § 78l(g) (2012).

⁹⁵ Pub. L. No. 112-106, § 303, 126 Stat. 306, 321 (codified at 15 U.S.C. § 78l(g)(6)).

⁹⁶ *See* Crowdfunding, SEC Release Nos. 33-9470 34-70741, 78 Fed. Reg. 66498, 66536. (proposed Nov. 5, 2013), <http://www.gpo.gov/fdsys/pkg/FR-2013-11-05/pdf/2013-25355.pdf>.

⁹⁷ *Id.* at 66536.

purposes of 1934 Act registration under section 12(g). This is bound up in the extraordinarily deregulatory thrust of section 4(6), which to us is the most aggressive feature of the JOBS Act but outside the scope of this Article. This connection between crowd funding and section 12(g) is fraught with ambiguity, as crowd-funded issuers will have to struggle with what it means for the shareholder to have “purchase[d] such securities in transactions described under section 4(6).” Does this also include downstream purchasers of those securities? What if those securities are exchanged for new ones? Suffice it to say for now, that nothing in the foregoing discussion would offer a principled basis for the crowd-funding exemption and its collateral effects. This is a pure trade-off of investor protection in the hope of job creation.⁹⁸

The SEC’s proposed rule does clarify the definitional ambiguity in this aspect of the CROWDFUND Act. Although the text of the rule simply provides that “the definition of held of record shall not include securities issued pursuant to the offering exemption under Section 4(a)(6) of the Securities Act,”⁹⁹ the proposal release indicates, in response to comments received in the rulemaking process, that the exemption travels with the security to subsequent holders.¹⁰⁰ However, the proposal release declines to exempt different securities issued to holders of crowdfunded securities in a restructuring, recapitalization, or similar transaction.¹⁰¹

The SEC identifies drawbacks of the rules it proposes under the CROWDFUND Act. Because the proposed ongoing reporting responsibilities under the CROWDFUND Act cease when an issuer voluntarily becomes a public company under the 1934 Act (i.e., without being required to do so under Section 12 of the 1934 Act):

[i]t is possible that an issuer that sells securities in reliance on Section 4(a)(6) could become an Exchange Act reporting company, but then deregister and go dark with potentially thousands of investors Under such an outcome, a significant number of investors in an issuer might be unable to obtain important information about that issuer, which could affect the liquidity and pricing of the securities these investors hold.¹⁰²

Without taking away from the overall substantive point or dramatic effect of the prose of Professors Langevoort and Thompson, I question whether the CROWDFUND Act’s exemption of holders of crowdfunded securities from the shareholder count under Section 12(g) of the 1934 Act “is a pure trade-off of investor protection in the hope of job

⁹⁸ Langevoort & Thompson, *JOBS Act*, *supra* note 19, at 365 n.122 (citations omitted).

⁹⁹ Crowdfunding, 78 Fed. Reg. at 66565.

¹⁰⁰ *Id.* at 66498 (“An issuer seeking to exclude a person from the record holder count would have the responsibility for demonstrating that the securities held by the person were initially issued in an offering made under Section 4(a)(6).”).

¹⁰¹ *Id.* (“Section 303 of the JOBS Act does not extend the exemption from Section 12(g) to different securities issued in a subsequent restructuring, recapitalization or similar transaction, so we are not proposing to exempt such securities at this time”).

¹⁰² *Id.* at 66536.

creation.”¹⁰³ Leaving aside the reference to a purported objective of job creation (a contention that is somewhat suspect but beyond the scope of this article), the few sentences in Professors Langevoort’s and Thompson’s footnote on the treatment of CROWDFUND Act investors for the purposes of 1934 Act publicness do not mention that Congress mandated a separate form of periodic public reporting for issuers availing themselves of the CROWDFUND Act registration exemption, less extensive than public company reporting.¹⁰⁴ “Title III provides for an alternative reporting system under which issuers would be required to file annual reports with the Commission.”¹⁰⁵ Yet, as earlier noted in the context of mandatory disclosure under the CROWDFUND Act, mandatory disclosure requirements under the CROWDFUND Act are not the equivalent of those under the registration and reporting regimes for registered public offerings and public companies under the federal securities laws before the advent of the CROWDFUND Act.¹⁰⁶ The capacity for transparency, accountability, and openness appears to exist but be diminished.

It is in this context that Professor Sale’s work sheds important light on the efficacy of the regulatory scheme under the CROWDFUND Act. In her first article on publicness, Professor Sale builds the case for a different, nonstatutory definition of publicness. “Public corporations,” she writes, “are not just creatures of Wall Street. They are creatures of Main Street, the media, bloggers, Congress, and the government.”¹⁰⁷ Given the genesis of the CROWDFUND Act as a grassroots effort to reform business finance grounded in social networking and ecommerce (i.e., the Internet) and in the desires of mainstream America (rather than Wall Street), crowdfunded companies may enjoy a new, special form of publicness. That publicness is created through an increased capacity, through the Internet, for relatively open inspection and through the ability of regulators and others external to the firm to react and effectively assert enforcement and governance privileges—a public response to the public nature of business challenges in Sale’s new era and form of publicness, “defined by scrutiny and government.”¹⁰⁸

Perhaps the exclusion of crowdfunded securities from the shareholder threshold in Section 12(g) of the 1934 Act is warranted as a matter of federal securities regulation because investor protection is achieved through compliance with the CROWDFUND Act’s alternative annual reporting scheme and the otherwise public nature of a business or project financed through crowdfunding, which together may force needed and appropriate changes in firm governance that adequately protect investors and market integrity while encouraging capital growth. Professor Sale labels this leveraging of mandatory disclosure an “information-forcing-substance regime.”¹⁰⁹

Governance is not just about relationships between officers, directors, and shareholders. Public companies operate in a public sphere, making public disclosures

¹⁰³ Langevoort & Thompson, *JOBS Act*, *supra* note 19, at 365 n.122.

¹⁰⁴ *See supra* notes 58–60 and accompanying text.

¹⁰⁵ Crowdfunding, 78 Fed. Reg. at 66498.

¹⁰⁶ *See supra* note 61 and accompanying text.

¹⁰⁷ *See Sale, New Corporation*, *supra* note 20, at 137.

¹⁰⁸ *See id.* at 140–41.

¹⁰⁹ *Id.* at 143.

on a regular basis. The SEC dictates what, when, why, and how much they must say. Corporations are also subject to media and blogging. So is the SEC. These factors combine to increase expectations about the SEC's role and pressure for the SEC to do something when things go wrong. That pressure shifts to corporations, their public disclosures, and their governance choices.¹¹⁰

In her subsequent writings on publicness, Professor Sale further explores this link between mandatory disclosure and the governance of the firm using the Sarbanes-Oxley Act of 2002,¹¹¹ the Dodd-Frank Wall Street Reform and Consumer Protection Act,¹¹² and the London Whale.¹¹³ She clarifies her theory that publicness involves a series of chain reactions that operate like a feedback loop—public scrutiny of firm governance exposes failings, those failings lead to external criticisms and demands for change, changes are made, public scrutiny is invited, and the cycle continues . . .¹¹⁴ She therefore describes publicness as “both a process and an outcome.”¹¹⁵ If Professor Sale is right, the transparency, accountability, and openness historically fostered by the 1934 Act may instead now be achieved—or at least be achievable—in crowd-funded issuers through the disclosures mandated under the CROWDFUND Act and the issuer's Internet presence.

Yet, the extent to which this optimal transparency, accountability, and openness will be achieved in issuers offering securities under the CROWDFUND Act will depend in part on both the nature of the mandatory disclosure obligations eventually adopted by the SEC in its implementing rulemaking and the amount of attention a particular issuer receives from regulators and the public. As earlier noted, the proposed SEC rules for mandatory disclosure under the CROWDFUND Act call for the publication of more limited information than is available for public companies.¹¹⁶ Moreover, as (if) securities crowdfunding becomes more popular, mainstream, and routinized, many small, less popular issuers of crowd-funded securities may be able to, in effect, hide in plain sight on the Internet. The computer algorithms that drive search engines may leave some of these crowd-funded issuers relatively unnoticed, much as other Internet-based securities fraud (e.g., pump-and-dump schemes) also flies under

¹¹⁰ *Id.* at 144.

¹¹¹ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

¹¹² Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

¹¹³ *See Sale, J.P. Morgan, supra* note 20, at 1636–42.

¹¹⁴ *See Sale, J.P. Morgan, supra* note 20, at 1630–31, 1655; Sale, *Governance, supra* note 20, at 1013-14. In her most recent work, she describes the feedback loop in the following way:

Corporations make choices, including, for example, choices about how the company handles certain events and how officers, directors, and shareholders interact with each other and the public. Once corporations communicate these choices to the world, the public develops an understanding of how the corporations have chosen to delegate power and responsibilities, as well as about where the gaps and weaknesses in governance might be. When public actors outside of the corporation reframe and retell the stories, those actors come to play a role in the corporation. Arguably, these outside actors can even become part of the governance rubric, creating pressure for changes in the decision-making structure or the allocation of power within the corporation.

Sale, *J.P. Morgan, supra* note 20, at 1630–31.

¹¹⁵ *Governance, supra* note 20 at 1013; *see* text accompanying note 43 *supra*.

¹¹⁶ *See supra* note 61 and accompanying text.

the radar, at least for a time.¹¹⁷ Lighter mandatory disclosure obligations and less public attention for crowdfunded issuers will limit the positive monitoring effects associated with Professor Sale's conceptualization of publicness.

CONCLUSION

Sometimes, an individual event represents or catalyzes a sea change. Although changes to the nature of public offerings and public company status had been occurring incrementally over time for a number of years,¹¹⁸ the JOBS Act, including the CROWDFUND Act, accelerated the pace of change and markedly blurred the boundaries between public and private offerings and public and private companies. The changes introduced in the JOBS Act are still new or, in the case of the CROWDFUND Act registration exemption provisions, as yet unimplemented. Studies are beginning to emerge, but it will be a number of years before we have data sufficient in amount and quality to test the efficacy of the rules Congress and the SEC have been writing into and under the JOBS Act.

It is likely that securities crowdfunding under the CROWDFUND Act will soon be implemented. This part of the JOBS Act includes innovative regulation at the public/private divide. Specifically, the CROWDFUND Act: (a) institutes a new exemption from registration under the 1933 Act for crowdfunded offerings of securities conducted in accordance with detailed requirements set forth in the Act and related SEC rules; and (b) exempts holders of equity securities acquired in an offering made in compliance with the statutory exemption from 1933 Act registration referenced in clause (a) from the count of shareholders under Section 12(g) of the 1934 Act (for purposes of determining, among other things, the applicability of the registration and reporting requirements under the 1934 Act). These changes to the registration requirements under the 1933 Act (which define public offerings) and the registration requirements under the 1934 Act (which represent a threshold to public company status) change the historical balance between publicness and privateness in U.S. federal securities regulation.

Important recent scholarship coauthored by Professors Don Langevoort and Bob Thompson enables us to begin to analyze these important changes under the 1933 Act and the 1934 Act. Specifically, these two legal scholars establish frameworks for analysis of the core meanings of public offering and public company status in the context of U.S. federal securities regulation. An analysis of the CROWDFUND Act using their ideas offers information important to the nascent regulation of securities crowdfunding in the United States.

Although SEC rulemaking is not yet complete, the expected changes to public offering regulation under the 1933 Act would represent a decreased emphasis on mandatory disclosure and SEC review, potentially uneven constraints on the sales pressure that may be used in the

¹¹⁷ See generally Peter Swire, *No Cop on the Beat: Underenforcement in E-Commerce and Cybercrime*, 7 J. TELECOMM. & HIGH TECH. L. 107, 126 (2009) (noting the difficulty in achieving securities fraud enforcement on the Internet given evolving strategies).

¹¹⁸ See Langevoort & Thompson, *JOBS Act*, *supra* note 14, at 343–51 (recounting the history of the line between public and private companies under the 1934 Act); Thompson & Langevoort, *Redrawing*, *supra* note 19, at 1588–1604 (describing and illustrating how the integration of the regulatory frameworks under the 1933 Act and the 1934 Act fostered transactional structures that avoided registered public offerings under the 1933 Act).

solicitation of investors, and relatively strong misstatement and omissions liability.¹¹⁹ The result of this hodge-podge may be the regulatory over-privatization of an offering that, under longstanding public policy and consistent with relevant theory, should be subject to rules closer to those involved in public offering regulation. Yet, the relative strength of the sales pressure restraints and liability regime may be enough to prevent and investor crisis or a significant lapse in market confidence, allowing for efficient capital formation.¹²⁰

Changes to public company regulation under the 1934 Act also offer us cause for pause. By exempting holders of securities purchased in offerings under the CROWDFUND Act from the shareholder count under Section 12(g) of the 1934 Act, the U.S. Congress has seemingly traded off the transparency, accountability, and openness of public company status under the 1934 Act for other objectives in a rather significant way.¹²¹ However, in the CROWDFUND Act, Congress did require issuers engaging in CROWDFUND Act offerings to file ongoing periodic reports after conclusion of the offering.¹²² These filings put the CROWDFUND Act issuer in a public disclosure position between a public company issuer and an issuer in a private placement of securities.

Having said that, it may be that the CROWDFUND Act creates a new form of public company altogether—one created by and interconnected with “a public-private dialectic that derives from the increasingly visible nature of corporations.”¹²³ The kinds of transparency, accountability, and openness associated with this type of public issuer may serve the policy objectives underlying federal securities regulation. A securities issuer that enjoys an open, public identity may invite regulatory and other public attention that results in externally imposed reforms or instigates self-regulation. The work of Professor Hillary Sale offers important insights along these lines.

An analysis of the regulation of offerings of securities under the CROWDFUND Act as a puzzle at the public/private divide exposes new and emerging complexity in distinguishing between public and private offerings under the 1933 Act and between public and private companies under the 1934 Act. The recognition of this complexity is important to SEC rulemaking and enforcement efforts under the CROWDFUND Act. The SEC should reflect on its initial and ongoing rulemaking under the CROWDFUND Act in the overall context of the strengths, weaknesses, and significance of salient regulatory categories and descriptors—including publicness and privateness. Regardless, the observations made may create new, more

¹¹⁹ See *supra* Part II.A.

¹²⁰ Professors Langevoort and Thompson intuit that sales pressure limitations and liability protections will be the most important of the four central investor protection features of the 1933 Act. Thompson & Langevoort, *Redrawing*, *supra* note 19, at 1586. Specifically, they observe as follows:

Were we to restate the law of public versus private offerings, we would say that the ‘33 Act is about regulating issuer or affiliate sales that are likely to result in a “dump” that will require special soliciting efforts, with the potential for abuse that entails. And if that is right, then we will need to pay special attention to the third and fourth features of the ‘33 Act: sales-practice regulation and liability.

Id.

¹²¹ See *supra* note 98 and accompanying text.

¹²² See *supra* notes 105–107 and accompanying text.

¹²³ Sale, *J.P. Morgan*, *supra* note 20, at 1631.

2016]

CROWDFUNDING AND THE PRIVATE/PUBLIC DIVIDE

153

finely tuned, categories of offerings and issuers that reflect the important values underlying preexisting, simpler taxonomies of offerings and issuers. As a result, U.S. federal securities regulation may move away from instructive, albeit somewhat outdated, facile, binary systems of classification like the public/private distinction and toward more nuanced classification systems that hold more descriptive power.

SOME KEY THINGS U.S. ENTREPRENEURS NEED TO KNOW ABOUT THE LAW AND LAWYERS

Lawrence J. Trautman*, Tony Luppino** & Malika Simmons***

OVERVIEW

Stanford business school Professor Edward P. Lazear observes that “[t]he entrepreneur is the single most important player in a modern economy.”¹ Bruce R. Barringer and R. Duane Ireland state that “[a]n entrepreneur assembles and then integrates all the resources needed the money, the people, the business model, the strategy, and the risk-bearing ability to transform the invention into a viable business.”² In addition, “entrepreneurship” has been defined as “the process by which individuals pursue opportunities without regard to resources they currently

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¹ Edward P. Lazear, *Entrepreneurship*, IZA Discussion Paper No. 760, 1 (2003), <http://ssrn.com/abstract=333802>.

² BRUCE R. BARRINGER & R. DUANE IRELAND, *ENTREPRENEURSHIP: SUCCESSFULLY LAUNCHING NEW VENTURES* (2d ed. 2008) (citing P. Sharma & J.J. Chrisman, *Toward a Reconciliation of the Definitional Issues in the Field of Corporate Entrepreneurship*, 23 *ENTREPRENEURSHIP THEORY & PRACTICE* 11 (1999), <http://cemi.com.au/sites/all/publications/Sharma%20and%20Chrisman%201999.pdf>).

control.”³ Lazear has defined an “entrepreneur” as “someone who responds affirmatively to the question ‘I am among those who initially established the business.’ Such individuals, even if they leave the business early, are usually responsible for the conception of the basic product, hiring the initial team, and obtaining at least some early financing.”⁴

A business, regulatory and tax environment conducive to the creation and growth of new businesses is the key to job growth. Small businesses are responsible for creation of 60 to 80 percent of net new employment since the mid-1990s.⁵ The U.S. Small Business Administration “found that net job creation in the immediate years following the 1990-1991 and 2001 recessions stemmed from employment generated by small firms with fewer than 500 employees.”⁶ Thus, all in our society have a vested interest in the nurturing and formation of new businesses. It is through this business formation process that jobs at all levels are created.⁷

Every entrepreneur must find talent to perform the numerous functional areas required for the enterprise to operate and thrive. Depending on the nature of the business, these functional areas and related core skills necessary for any business to become successful will likely include: a visionary, driven to succeed; an operations manager (or “field marshal”); finance; accounting; legal; marketing; information technology and social media; and industry-specific expertise (*e.g.*, petroleum engineer skills for an oil and gas company, software engineering for a software company, or medical training and expertise for a medical device company).

Every enterprise requires legal advice to successfully navigate the maze of regulatory and business problems. Professor Robert C. Bird even goes so far as to suggest that strategic legal resources can be employed as “sources of sustainable competitive advantage.”⁸ Our purpose in writing this paper is to highlight some of the more common and significant issues entrepreneurs need to know about regarding laws and working with lawyers. Typically, start-up ventures in the United States may implicate many diverse areas of law. Our intent is not to present an exhaustive and lengthy study, but rather a short and useful discussion that is of practical value to an entrepreneur looking to get an initial introduction to the role of laws and lawyers in planning and launching a start-up venture. We hope this will inspire the entrepreneur to then dig deeper into books and other resources that engage in more in-depth treatment of various legal issues in the context of enterprise planning.⁹

³ *Id.* at 6 (citing H.H. Stevenson & J.C. Jarillo, *A Paradigm for Entrepreneurship: Entrepreneurial Management*, 11 STRATEGIC MGMT. J. 17 (1990)).

⁴ Lazear, *supra* note 1, at 2–3.

⁵ Vivek Wadhwa, Raj Aggarwal, Krisztina Holly & Alex Salkever, *Making of A Successful Entrepreneur: Anatomy of an Entrepreneur Part II*, 4 (Kauffman Foundation Small Res. Projects Res. Paper No. 2, 2009), <http://ssrn.com/abstract=1507384>.

⁶ *Id.* (citing U.S. Small Business Administration, Office of Advocacy, *The Small Business Economy*, Washington (2009)).

⁷ See Ana Campoy, *Policy, Geography Boost Texas Job Growth*, THE WALL ST. J., Aug. 22, 2011, at A4, <http://www.wsj.com/articles/SB10001424053111904279004576522410781190414>.

⁸ See Robert C. Bird, *Can Law Be a Source of Sustainable Competitive Advantage?*, 1 (May 15, 2007), <http://ssrn.com/abstract=985704>. See also Robert C. Bird & David Orozco, *Finding the Right Corporate Legal Strategy*, MIT SLOAN MGMT. REV. (Sept. 16, 2014), <http://sloanreview.mit.edu/article/finding-the-right-corporate-legal-strategy/>.

⁹ See, *e.g.*, CONSTANCE E. BAGLEY AND CRAIG E. DAUCHY, THE ENTREPRENEUR’S GUIDE TO BUSINESS LAW,

First, we present below an initial overview of commonly encountered start-up legal issues and considerations involved in finding the right lawyer(s) to help deal with them. Second, the strategic importance of information technology, social media, and intellectual property is explored. Third, choices of entity considerations are discussed. Fourth, laws pertaining to raising early-stage capital are addressed. Fifth, we examine sources of early-stage capital. Sixth, is a discussion of creditor rights and bankruptcy considerations. Seventh, we focus on legal issues raised by the employer-employee relationship. Next, we briefly discuss the importance of risk awareness and risk management. We then offer a few concluding thoughts regarding the efficient use of lawyers and the importance of an entrepreneur developing familiarity with legal issues and engaging legal counsel to address them as part of the planning and implementation of the business venture.

START-UP LEGAL ISSUES AND FINDING THE RIGHT LAWYER

All of us owe much to those individuals who (against the odds) risk their finite time and personal net worth in the attempt to create a successful business. To survive, all successful entrepreneurs of necessity have become skillful at optimizing efficiency at every opportunity. Entrepreneurs also need to deal with what may often seem to them an endless maze of laws and regulations, some of them presenting hurdles, and others opportunities. This requires that they become educated on spotting areas of law they will encounter and engaging qualified legal counsel to guide them—which, given the many specialty areas of law that now exist, may well and often does mean hiring more than one lawyer.

The Start-Up and Legal Considerations

A typical start-up venture in the United States will likely implicate many of the following areas of law: intellectual property; business organizations; tax; employment and labor; securities regulation; contracts and licensing agreements; commercial sales; debtor-creditor relations; real estate; health and safety; permits and licenses; environmental protection; industry specific regulatory laws and approval processes; tort or personal injury, products liability, insurance; antitrust and other unfair competition; import/export; immigration; related to the internet, privacy, e-commerce, and consumer protection; and possibly many other federal, state or local laws; and, for many businesses these days, international.

At the most basic level, all successful start-ups have the same fundamental requirements, regardless of specific industry. Building the foundation for any successful enterprise is analogous to constructing a structurally sound foundation for your house. Careful preparation before work begins is essential. You can always go back and try to repair a faulty foundation after you have attempted to place a structure on top; but, such an effort will likely prove costly, disruptive and a waste of limited management team resources. A core set of skills is necessary for any business to become successful. Legal talent, either “in house” or outside the enterprise

(4th ed., Cengage Learning 2011); DWIGHT DRAKE, BUSINESS PLANNING: CLOSELY-HELD ENTERPRISES (3d ed., West 2011). *See also* the annotated bibliography of law and entrepreneurship publications in the Law Scholarship section of the Entrepreneurship Law website (hereinafter “ESHIPLAW.ORG”) powered by the Ewing Marion Kauffman Foundation and maintained by the University of Missouri-Kansas City School of Law, <http://www.eshiplaw.org/resources/law-scholarship> (last visited July 24, 2016).

is required.

When to Engage a Lawyer

How does an entrepreneur know if and when he or she needs to engage a lawyer? This can be a very challenging question. Can the entrepreneur really afford to pay for legal advice before his or her business plan has reached a level of feasibility to justify that expense? At the same time, are there risks in waiting too long? The answer to the second question is most certainly “yes.” Not getting legal advice can cause a multitude of mistakes that can prove costly, and perhaps disastrous. For example, an entrepreneur might accidentally make disclosures that erode or preclude the ability to protect intellectual property, create ownership rights in other people or entities that the entrepreneur did not consider “partners,” cause unintended adverse tax consequences, or violate securities regulation laws in ways that lead to civil or criminal liability and inhibit the ability to raise capital going forward.

There is no simple answer as to exactly when to hire one or more lawyers to help avoid these or other legal problems. Common mistakes we have seen entrepreneurs make do allow us to suggest some scenarios that should trigger the need to get legal counsel. These include: (1) when any significant prospect of creating intellectual property arises, (2) whenever considering working with anyone else who might argue they have “a piece of the deal,” (3) whenever thinking about borrowing any money from anyone for the venture or issuing or committing to issue anyone an ownership interest or option to acquire an ownership interest, and (4) when hiring any service provider, and especially one who may be an employee. Those are certainly not the only times when an entrepreneur needs legal advice, but they are indicative of some of the more commonly arising situations in which such advice is of critical importance.

Finding the Right Legal Talent

How likely is it that one lawyer is truly well versed in all of the areas of law potentially affecting a venture? Lawyers come with varying degrees of relevant experience and training. Attorneys practicing law in the U.S. are generally required to earn a professional degree (J.D. in U.S. or comparable degree from study in another country), may also hold an advanced law degree (e.g., an LL.M), and with few exceptions must have passed a bar exam, and may have accumulated experience gained as a result of legal practice in the relevant areas of law (communications, employment law, entertainment, intellectual property, international business, oil and gas, tax, and securities law are all examples of areas that can require significant time for a lawyer to gain facility). For the first-time entrepreneur, a host of diverse legal issues will present themselves in areas such as entity choice and formation, initial capitalization and fundraising, taxation, employment law, contracts, and intellectual property considerations. Luppino observes:

[F]or a lawyer to be viewed by his or her client as an effective counselor, the client must first recognize and appreciate the value of having a good lawyer on the client’s team, and then decide that the lawyer in question is indeed a good one. Both of these assessments may require overcoming some stereotypes and determining what really

counts and what the skill level, integrity and commitment of a particular lawyer really are.¹⁰

Finding the right lawyer is somewhat like the search to find an appropriate surgeon. Just as you would not want a foot specialist operating on your brain, it is usually not a good idea to approach a “generalist” lawyer who specializes in family or criminal law to handle complex tax or securities law matters. Luppino cautions that:

Soon, the entrepreneur will recognize that chances are his or her lawyer will not be an expert in all of the areas of law that may touch a business venture. So, a lawyer who is a ‘networker’ may be desirable (or essential). The entrepreneur will also quickly be made aware that many of the laws to be addressed will restrict or preclude avenues that were—before the lawyers were brought in—viewed as viable paths toward success. In other words, the entrepreneur’s lawyers may often have to be messengers of bad news, and accordingly appear to be masters of ‘no, you can’t do that’—which is why many consumers of business law services are quite naturally inclined to hope to find . . . ‘can do’ lawyers.¹¹

Therefore, the goal of entrepreneurial lawyer identification and recruitment is to find those knowledgeable lawyers who “have also developed significant business savvy and creativity, and who use their training in seeing all sides of an argument to become extremely valuable sounding boards for their clients, sometimes participating in the design and engineering, and often at least quarterbacking, the negotiation of their key transactions.”¹²

Lawyers and Fees

What kinds of fees do lawyers typically charge? Are they negotiable? It is fairly common for business lawyers to use an hourly rate approach to fees for services related to organizing a business. The rates can vary greatly from lawyer to lawyer depending on a number of market conditions and levels of training and experience. Moreover, the bill is of course not based solely on the hourly rate; rather, it is based on that rate multiplied by the number of hours billed on the engagement. The client, especially if a first-time entrepreneur, is not in a particularly good position to estimate how many hours will actually be involved, thus making

¹⁰ Anthony J. Luppino, *Can Do: Training Lawyers to Be Effective Counselors to Entrepreneurs – Report to the Ewing Marion Kauffman Foundation*, 1, 6 (Jan. 30, 2008), <http://ssrn.com/abstract=1157065>.

¹¹ *Id.* at 7. See also BAGLEY & DAUCHY, *supra* note 9, at ch. 3 (“Selecting and Working with an Attorney”).

¹² Luppino, *supra* note 10, at 8 (citing Ronald Gilson, *Value Creations by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L. J. 239 (1984)) (contending that lawyers add value as ‘transaction cost engineers’ and ‘reputational intermediaries’). See also Ronald J. Gilson & Robert H. Mnookin, *Foreword: Business Lawyers and Value Creation for Clients*, 74 OR. L. REV. 1 (1995); Steven L. Schwarcz, *Explaining the Value of Transactional Lawyering*, 12 STAN. J. L. BUS. & FIN. 486 (2007); Anthony J. Luppino, *The Value of Lawyers as Members of Entrepreneurial Teams*, in HANDBOOK ON LAW, INNOVATION AND GROWTH, ch. 12 (Robert Litan ed., 2011); Robert C. Bird, *The Many Futures of Legal Strategy*, 47 AM. BUS. L.J. 575 (2010); Constance E. Bagley, *What’s Law Got to Do With It?*, 47 AM. BUS. L.J. 587 (2010); George J. Siedel & Helena Haapio, *Using Protective Law for Competitive Advantage*, 47 AM. BUS. L.J. 641 (2010); Larry A. DiMatteo, *Strategic Contracting: Contract Law as a Source of Competitive Advantage*, 47 AM. BUS. L.J. 727 (2010).

budgeting for legal expense a difficult and uncertain proposition. It is possible to ask for discounted rates, and to get a plan that will involve having attorneys at lower hourly rates perform services they can perform well and efficiently, bringing in more senior lawyers (with higher hourly rates) on only an “as needed” basis.

What about a fixed fee for a discrete piece of transactional work (such as forming a corporation or limited liability company), or an hourly rate fee but with a dollar amount maximum/cap? Fixed fees can be a matter of negotiation and do make budgeting easier. However, the entrepreneur should consider what might be in the head of the lawyer who has already (on an hourly basis equivalent) hit the max on the matter in terms of the dollar amount of time that can be billed to the client under the arrangement and has to decide how to prioritize his or her work on the matter with other clients’ work (which may be on the clock at hourly rates). The lawyer is of course subject to discipline under rules of attorney conduct and potential liability for malpractice should he or she neglect or otherwise fail to fulfill obligations to the client; but questions of prioritization in the context of having multiple clients may make it difficult to draw clear lines of enforcement of the attorney’s duties in this type of situation.

How about an entrepreneur with limited cash at the early stage of a venture proposing to pay a lawyer with an equity interest in the venture in lieu of a cash fee? Despite the risk of conflicts of interest inherent in that type of arrangement, it is possible for a lawyer to ethically accept that kind of deal if done properly and in the right circumstances.¹³ The entrepreneur should of course consider whether that may be penny wise and pound foolish—might that equity interest turn out to be much more generous to the lawyer than the entrepreneur contemplated?¹⁴ In addition, issuing equity for services is within the ambit of the securities laws discussed later in this paper as an issue to be considered when issuing investment units for services, money or other property.

Is an entrepreneur better off hiring a big law firm or a solo, small or medium-sized law firm? Again, no easy answer to this. A large firm with multiple departments (intellectual property, tax, business law, employment law, etc.) can offer the advantage of relatively one-stop-shopping to cover a diverse set of legal needs. But a solo, small, or medium law firm may have less overhead, more affordable fees, and a good network to bring in outside “specialists”¹⁵ when needed. There is simply no perfect answer. The good news is that the

¹³ See generally ABA Comm. On Ethics & Prof’l Responsibility, Formal Op. 00-418 (2000) (discussing acquiring ownership in a client in connection with performing legal services). See also Poonam Puri, *Taking Stock of Taking Stock*, 87 CORNELL L. REV. 99 (2001).

¹⁴ See, e.g., *Passante v. McWilliam*, 62 Cal. Rptr. 2d 298 (Cal. Ct. App. 1997) (3% of stock promised to lawyer for “rookie baseball card company” turned out to be worth approximately \$33 million; jury found for lawyer in suit to enforce that deal, but trial court and appellate court overturned that and held that the company did not have to make good on what was found to be just an unenforceable “moral” promise to make a gift to the attorney on the particular facts of that case).

¹⁵ We mean here “specialists” in the sense of substantial experience in particularly challenging areas of law. Lawyers are generally subject to restrictions as to when and how they may hold themselves out as specialists in a formal sense. See, e.g., A.B.A. MODEL RULES OF PROF’L CONDUCT r. 7.4(d) (West 2014) (“A lawyer shall not state or imply that a lawyer is certified as a specialist in a particular field of law, unless: (1) the lawyer has been certified as a specialist by an organization that has been approved by an appropriate state authority or that has been accredited by the American Bar Association; and (2) the name of the certifying organization is clearly identified in the

entrepreneur can interview lawyers and negotiate a tailored deal if the entrepreneur is willing to take the time to do that, preferably with some recommendations by trusted mentors who have “been around the block” as consumers of legal services.

Can one lawyer represent multiple owners in forming a business entity for the venture? The American Bar Association’s Model Rules of Professional Conduct say “yes” in limited circumstances.¹⁶ That approach may be cost efficient, but the entrepreneurs involved still might think twice before going that route; there is a lot to be said for having your own lawyer focused on your individual interests.

Do any lawyers help start-up entrepreneurs on a *pro bono* (i.e., no charge) basis?

In view of the key role entrepreneurship plays in job creation and economic growth it is not surprising that there are indeed some avenues for start-up entrepreneurs, especially entrepreneurs of limited financial means, to obtain some *pro bono* legal services in launching their ventures. For example, several U.S. law schools have clinics that assist entrepreneurs in their communities,¹⁷ and the U.S. Patent & Trademark Office has been promoting the creation of *pro bono* initiatives by intellectual property lawyers to assist inventors.¹⁸ Entrepreneurs should consider those and other options for free legal assistance they may find if they do some research and explore possibilities with organizations supporting entrepreneurship and innovation in their regions.

INFORMATION TECHNOLOGY AND INTELLECTUAL PROPERTY

Information Technology and Social Media

Social media, the technological development that represents a global cultural sea change within recent years, dictates a must-have functional skill for almost every contemporary enterprise.¹⁹ Marketing channels have changed dramatically during the past decade.²⁰ The

communication.”).

¹⁶ See A.B.A. MODEL RULES OF PROF’L CONDUCT r. 1.7 cmt. 28 (West 2014) (“Whether a conflict is consentable depends on the circumstances. For example, a lawyer may not represent multiple parties to a negotiation whose interests are fundamentally antagonistic to each other, but common representation is permissible where the clients are generally aligned in interest even though there is some difference in interest among them. Thus, a lawyer may seek to establish or adjust a relationship between clients on an amicable and mutually advantageous basis; for example, in helping to organize a business in which two or more clients are entrepreneurs, working out the financial reorganization of an enterprise in which two or more clients have an interest or arranging a property distribution in settlement of an estate. The lawyer seeks to resolve potentially adverse interests by developing the parties’ mutual interests. Otherwise, each party might have to obtain separate representation, with the possibility of incurring additional cost, complication or even litigation. Given these and other relevant factors, the clients may prefer that the lawyer act for all of them.”).

¹⁷ *Law School Entrepreneurship Clinics in the United States*, ESHIPLAW.ORG, <http://www.eshiplaw.org/entrepreneurship-clinics-maps> (last visited July 24, 2016) (providing a state-by-state list of law school entrepreneurship clinics).

¹⁸ *Patent Pro Bono Program*, U.S. PATENT & TRADEMARK OFFICE, <http://www.uspto.gov/patents-getting-started/using-legal-services/pro-bono/patent-pro-bono-program> (last visited July 3, 2016).

¹⁹ See generally Michael Trusov, Randolph E. Bucklin & Koen H. Pauwels, *Effects of Word-of-Mouth Versus Traditional Marketing: Findings from an Internet Social Networking Site*, 73 J. MKTG. 90 (2009),

<http://ssrn.com/abstract=1129351>; Anindya Ghose & Panagiotis G. Ipeirotis, *Estimating the Helpfulness and Economic Impact of Product Reviews: Mining Text and Reviewer Characteristics*, 23 IEEE TRANSACTIONS ON KNOWLEDGE & DATA ENG'G 1498 (2011), <http://ssrn.com/abstract=1261751>; Frank T. Piller, Alexander Vossen & Christoph Ihl, *From Social Media to Social Product Development: The Impact of Social Media on Co-Creation of Innovation*, 65 DIE UNTERNEHMUNG 7 (2012), <http://ssrn.com/abstract=1975523>; Donna L. Hoffman & Thomas P. Novak, *Why Do People Use Social Media? Empirical Findings and a New Theoretical Framework for Social Media Goal Pursuit* (Jan. 17, 2012), <http://ssrn.com/abstract=1989586>; Jeong-ha Oh, Anjana Susarla & Yong Tan, *Examining the Diffusion of User-Generated Content in Online Social Networks* (July 28, 2008), <http://ssrn.com/abstract=1182631>; Rebecca Walker Naylor, Cait Poyner Lamberton & Patricia M. 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²⁰ See generally Urs Gasser, Sandra Cortesi, Momin M. Malik & Ashley Lee, *Youth and Digital Media: From*

2016] SOME KEY THINGS U.S. ENTREPRENEURS NEED TO KNOW 163

opportunities and pitfalls of such new technologies as Facebook,²¹ Google,²² GPS or location-

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²¹ See generally Dokyun Lee, Kartik Hosanagar & Harikesh S. Nair, *Advertising Content and Consumer Engagement on Social Media: Evidence from Facebook* (Sept. 2015), <http://ssrn.com/abstract=2290802>; Jörg Claussen, Tobias Kretschmer & Philip Mayrhofer, *The Effects of Rewarding User Engagement – The Case of Facebook Apps*, 24 INFO. SYS. RES. 186 (2013), <http://ssrn.com/abstract=1599458>; Sharad Borle, Utpal M. Dholakia, Siddharth S. Singh & Emily Durham, *The Impact of Facebook Fan Page Participation on Customer Behavior: An Empirical Investigation* (Oct. 22, 2013), <http://ssrn.com/abstract=2555994>; M. Laeeq Khan & Jan Boehmer, *Small Business Use of Facebook for Marketing: The Case of a Family Owned Mediterranean Restaurant*, 78th Ann. Int'l Convention Ass'n for Bus. Comm., N. Orleans, La. (Oct. 23–26, 2013), <http://ssrn.com/abstract=2579508>; Catherine Tucker, *Social Advertising: How Advertising that Explicitly Promotes Social Influence Can Backfire* (Jun. 3, 2016), <http://ssrn.com/abstract=1975897>; Jonah A. Berger & Eva Buechel, *Facebook Therapy? Why People Share Self-Relevant Content Online*, 40 ADVANCES IN CONSUMER RES. 203 (2012), <http://ssrn.com/abstract=2013148>; Felix Köbler, Christoph Riedl, Céline Vetter, Jan Marco Leimeister & Helmut Krcmar, *Social Connectedness on Facebook: An Explorative Study on Status Message Usage*, Procs. of the 16th Ams. Conf. on Info. Sys., Lima, Peru (Aug. 12–15, 2010), <http://ssrn.com/abstract=1641178>; Sunghun Chung, Animesh Animesh, Kunsoo Han & Alain Pinsonneault, *Firms' Social Media Efforts, Consumer Behavior, and Firm Performance: Evidence from Facebook* (June 10, 2014), <http://ssrn.com/abstract=2448510>; Johan Egebark & Mathias Ekström, *Like What You Like or Like What Others Like? Conformity and Peer Effects on Facebook* 886 (IFN Working Paper No. 886, 2011), <http://ssrn.com/abstract=1948802>; James Grimmelmann, *Privacy as Product Safety*, 19 WIDENER L.J. 793 (2010); Bassel Tarbush & Alexander Teytelboym, *Social Groups and Social Network Formation* (Sept. 2, 2015), <http://ssrn.com/abstract=2456532>; Vaibhav Garg, Kevin Benton & L. Jean Camp, *The Privacy Paradox: A Facebook Case Study*, 2014 TPRC Conf. (2014), <http://ssrn.com/abstract=241167>; Sarah Spiekermann, Christine Bauer & Jana Korunovska, *On the Value of Information – What Facebook Users are Willing to Pay*, 20th Eur. Conf. on Info. Sys. (May 5, 2012),

based mobile services,²³ IM,²⁴ LinkedIn,²⁵ mobile internet,²⁶ paid search,²⁷ streaming media,²⁸ and Twitter²⁹ need to be understood and utilized. For most enterprises in this environment, if a company's management and marketing strategy is not focused on social media, some very powerful marketing channels are being overlooked.³⁰

Few enterprise operational areas present as much inherent risk or prove as difficult to

<http://ssrn.com/abstract=2050916>.

²² See generally Florence Thépot, *Market Power in Online Search and Social-Networking: A Matter of Two-Sided Markets*, 36 W. COMP. 195 (2013), <http://ssrn.com/abstract=2307009>.

²³ See generally Zhuping Liu, Jason A. Duan & Frenkel Ter Hofstede, *Marketing Spillovers of Location-Based Mobile Services* (Sept. 1, 2014), <http://ssrn.com/abstract=2578335>; Matthew W. Wilson, *Location-Based Services, Conspicuous Mobility, and the Location-Aware Future*, 43 GEOFORUM 1266 (2012), <http://ssrn.com/abstract=2181053>; Dirk Grunwald, Aaron Beach, Kevin Bauer, Qin Lv & Douglas Sicker, *The Risks and Regulation of Location*, 2010 TPRC Conf., <http://ssrn.com/abstract=1989200>; Bart Lariviere, Herm Joosten, Edward Malthouse, Marcel Van Birgelen, Pelin Aksoy, Werner H. Kunz & Ming-Hui Huang, *Value Fusion: The Blending of Consumer and Firm Value in the Distinct Context of Mobile Technologies and Social Media* (Aug. 7, 2013), <http://ssrn.com/abstract=2307058>.

²⁴ See generally Jeffrey Bellin, *Facebook, Twitter, and the Uncertain Future of Present Sense Impressions*, 160 U. PA. L. REV. 331 (2012).

²⁵ Rajiv Garg & Rahul Telang, *To Be or Not To Be Linked on LinkedIn: Job Search Using Online Social Networks* (Apr. 18, 2011), <http://ssrn.com/abstract=1813532>.

²⁶ See generally Anindya Ghose, Avi Goldfarb & Sang Pil Han, *How is the Mobile Internet Different? Search Costs and Local Activities*, 24 INFO. SYS. RES. 613 (2012), <http://ssrn.com/abstract=1732759>.

²⁷ See generally Anindya Ghose, Panagiotis G. Ipeirotis & Beibei Li, *Examining the Impact of Ranking on Consumer Behavior and Search Engine Revenue*, 60 MGMT. SCI. 1632 (2014), <http://ssrn.com/abstract=2264354>.

²⁸ See generally Olufunmilayo B. Arewa, *Youtube, UGC, and Digital Music: Competing Business and Cultural Models in the Internet Age*, 104 NW. U. L. REV. 431 (2010), <http://ssrn.com/abstract=1892329>.

²⁹ See generally Alfred Hermida, *From TV to Twitter: How Ambient News Became Ambient Journalism*, 13 MEDIA/CULTURE J. 1 (2010), <http://journal.media-culture.org.au/index.php/mcjournal/article/viewArticle/220>; Andrew B. Whinston & Huaxia Rui, *Social Media as an Innovation - The Case of Twitter* (Mar. 10, 2010), <http://ssrn.com/abstract=1564205>; Samuel Fosso Wamba & Lemuria Carter, *Twitter Adoption and Use by SMEs: An Empirical Study*, 46th Haw. Int'l Conf. on Sys. Sci. (HICSS), Maui, Haw. (Jan. 7–10, 2013), <http://ssrn.com/abstract=2137479>; Shiyang Gong, Juanjuan Zhang, Ping Zhao & Xuping Jiang, *Tweets and Sales* (July 1, 2014), <http://ssrn.com/abstract=2461370>; Richard E. Custin, Kathleen Britton & Sharon Yarak, *A Tweet on Social Media for Your Business*, CAL. BUS. PRAC. (2014), <http://ssrn.com/abstract=2374247>; Juliet M. Moringiello, *Notice, Assent, and Form in a 140 Character World*, 44 SW. L. REV. 275 (2014), <http://ssrn.com/abstract=2491249>; Svetlana Rybalko & Trent Seltzer, *Dialogic Communications in 140 Characters or Less: How Fortune 500 Companies Engage Stakeholders Using Twitter?*, 36 PUB. REL. REV. 336 (2010); Christoph Riedl, Felix Köbler, Suparna Goswami & Helmut Krcmar, *Tweeting to Feel Connected: A Model for Social Connectedness in Online Social Networks*, 29 INT'L J. HUM.-COMPUTER INTERACTION 670 (2013).

³⁰ See generally Derek Slater, Urs Gasser, Meg Smith, Derek E. Bambauer & John G. Palfrey, *Content and Control: Assessing the Impact of Policy Choices on Potential Online Business Models in the Music and Film Industries* (Berkman Publication Series Paper No. 2005-01, 2005), <http://ssrn.com/abstract=654602>; Anindita Chakravarty, Yong Liu & Tridib Mazumdar, *The Differential Effects of Online Word-of-Mouth and Critics' Reviews on Pre-Release Movie Evaluation*, 24 J. INTERACTIVE MKTG. 185 (2010), <http://ssrn.com/abstract=1949821>; Terry Daugherty & Ernest Hoffman, *eWOM and the Importance of Capturing Consumer Attention within Social Media*, 20 J. MKTG. COMM. 82 (2014), <http://ssrn.com/abstract=2567567>; Yichuan Wang & M. Nick Hajli, *Co-Creation in Branding Through Social Commerce: The Role of Social Support, Relationship Quality and Privacy Concerns*, Procs. of 20th Ams. Conf. on Info. Sys., Savannah, Ga. (2014), <http://ssrn.com/abstract=2449127>.

2016] SOME KEY THINGS U.S. ENTREPRENEURS NEED TO KNOW 165

govern as Information Technology (IT).³¹ Even in mature companies, seasoned corporate directors are asking, “How can I be expected to govern something I know so little about?”³² Trautman and Altenbaumer-Price have observed that for almost every enterprise “IT is fundamental to support, sustain, and grow the business. Yet, in a recent survey of 5,500 business leaders worldwide, ‘58 percent of executives polled said they have lost sensitive personal information, and for nearly 60 percent of those who have had a breach, it was not an isolated event.’”³³ Moreover:

During recent years, IT risk has demonstrated the potential to cause catastrophic losses to the enterprise balance sheet, reputation, and even threaten its very existence . . . examples of the effects of an IT failure include: loss of sensitive customer private information; loss of sensitive product or financial data of the corporation; virus attacks by hackers on the company’s computer systems and those of its customers or vendors; business interruption losses due to IT downtime; as well as theft and use of client credit card or other sensitive data.³⁴

Each start-up possesses different levels of Information Technology experience and skills. For example, while an early-stage software or new social media company may be inundated with engineering and IT talent, expertise and understanding, an agricultural, fast food or oil and gas start-up may have few IT resources and little IT experience among its management team. These days, almost every start-up has a website, regardless of industry or mission. For those entrepreneurs engaged in any form of e-commerce, a tremendous amount of often unanticipated risk exposure may result. Elsewhere, one of your authors has presented relevant annual report risk disclosures from eBay (parent of PayPal), along with other eBay and PayPal documents to illustrate perceived legal risks in a major e-commerce enterprise engaged in

³¹ See generally Lawrence J. Trautman & Kara Altenbaumer-Price, *The Board’s Responsibility for Information Technology Governance*, 29 J. MARSHALL J. OF COMP. & INFO. L. 313 (2011), <http://ssrn.com/abstract=1947283>; Lawrence J. Trautman, Jason Triche & James C. Wetherbe, *Corporate Information Technology Governance Under Fire*, 8 J. STRATEGIC & INT’L STUD. 105 (2013), <http://ssrn.com/abstract=2346583>; Lawrence J. Trautman, *Managing Cyberthreat*, 31 SANTA CLARA HIGH TECH. L.J. (2015), <http://ssrn.com/abstract=2534119>; Lawrence J. Trautman, *Cybersecurity: What About U.S. Policy?*, 2015 J. L. TECH. & POL’Y 341 (2015), <http://ssrn.com/abstract=2548561>; Nancy J. King & V.T. Raja, *What Do They Really Know About Me in the Cloud? A Comparative Law Perspective on Protecting Privacy and Security of Sensitive Consumer Data*, 50 AM. BUS. L.J. 413 (2013).

³² See Trautman & Altenbaumer-Price, *supra* note 31, at n. 1 (highlighting that “Peter Weill and Jeanne W. Ross depict Information Technology as one of the ‘six key assets for any enterprise’ (the others being human, physical, financial, intellectual property and relationships)”; see also Peter Weill & Jeanne W. Ross, *IT Governance: How Top Performers Manage It Decision Rights For Superior Results* 1–7 (Harv. Bus. Sch. Press 2004). Peter Weill, Director of the Center for Information Systems Research (CISR) and Senior Research Scientist at the Massachusetts Institute of Technology’s Sloan School of Management, led research during 2001–2003, which studied 256 enterprises in Europe, Asia Pacific and the Americas. *Id.* Jeanne Ross and Cynthia Beath (University of Texas) were conducting parallel studies during the same general time period. *Id.*

³³ Trautman & Altenbaumer-Price, *supra* note 31, at 326 (citing Accenture Report, *How Global Organizations Approach the Challenge of Protecting Personal Data*, at 15 (2010), <http://www.ponemon.org/blog/how-global-organizations-approach-the-challenge-of-protecting-personal-data>).

³⁴ *Id.* (citing USI Insurance Services, *Cyber Liability/Security and Privacy Insurance* (2009) (on file with the authors)). See also BAGLEY & DAUCHY, *supra* note 9, at 516 and in ch. 14 (“Intellectual Property and Cyberlaw”) generally.

receiving payments.³⁵

Value of Intellectual Property

While intellectual property (IP) considerations may not be mission-critical for all start-ups, for many, IP protection will be essential.³⁶ For many technology or pharmaceutical enterprises, their IP portfolios constitute their most significant assets.³⁷ Examples of valuable intellectual property “intangible assets” include: advertising,³⁸ brand identity,³⁹ celebrity endorsements, copyrights,⁴⁰ creative content, designs,⁴¹ domain names,⁴² fragrance,⁴³ logos,

³⁵ See Lawrence J. Trautman, *E-Commerce and Electronic Payment System Risks: Lessons From PayPal*, 16 U.C. DAVIS BUS. L.J. (forthcoming), <http://ssrn.com/abstract=2314119>.

³⁶ See generally Roger D. Blair & Thomas F. Cotter, *An Economic Analysis of Seller and User Liability in Intellectual Property Law* (1999), <http://ssrn.com/abstract=146235>; As resources for entrepreneurs to get some IP background, please see the following governmental links: *Inventor & Entrepreneur Resources*, U.S. PATENT & TRADEMARK OFFICE, <http://www.uspto.gov/inventors/index.jsp>; *Inventors Assistance Center (IAC)*, U.S. PATENT & TRADEMARK OFFICE, <http://www.uspto.gov/inventors/iac/index.jsp>; *Patent FAQs*, U.S. PATENT & TRADEMARK OFFICE, <http://www.uspto.gov/faq/patents.jsp>; *Trademark FAQs*, U.S. PATENT & TRADEMARK OFFICE, <http://www.uspto.gov/faq/trademarks.jsp>; and U.S. COPYRIGHT OFFICE, <http://www.copyright.gov> (all last visited July 3, 2016). See also Sapna Kumar, *Regulating Digital Trade*, 67 FLA. L. REV. 1909; Mark A. Lemley, *Ex Ante Versus Ex Post Justifications for Intellectual Property*, 71 U. CHI. L. REV. 129 (2004); Yoni Pruzansky & Liad Wagman, *Intellectual Property Protection and Firm Innovation* (Mar. 22, 2015), <http://ssrn.com/abstract=2583524>; Wen Wen, Marco Ceccagnoli & Chris Forman, *Opening Up IP Strategy: Implications for Open Source Software Entry By Start-Up Firms*, MGMT. SCI. (forthcoming), <http://ssrn.com/abstract=2590198>.

³⁷ See generally Ed Silverman, *Battling FDA to Fend Off Generic Rivals*, WALL ST. J., Apr. 17, 2015 at B2 (observing that Abilify generated sales of \$4.9 billion during 2014, but faces the loss of patent protection next week).

³⁸ See Lisa P. Ramsey, *Intellectual Property Rights in Advertising*, 12 MICH. TELECOMM. & TECH. L. REV. 189 (2006), <http://ssrn.com/abstract=969037>.

³⁹ See generally Deven R. Desai, Ioannis Lianos & Spencer Weber Waller, *Brands, Competition Law and IP* (Cambridge Univ. Press, forthcoming 2015), <http://ssrn.com/abstract=2584509>; Julie Manning Magid, Anthony D. Cox & Dena S. Cox, *Quantifying Brand Image: Empirical Evidence of Trademark Dilution*, 43 AM. BUS. L.J. 1 (2006); *2014 Best Global Brands*, INTERBRAND, <http://bestglobalbrands.com/2014/ranking> (last visited July 3, 2016) (providing a list of the world's top 100 brands).

⁴⁰ See generally Oren Bracha, *Standing Copyright Law on its Head? The Googlization of Everything and the Many Faces of Property*, 85 TEX. L. REV. 1799 (2007); Robert Brauneis, *Copyright and the World's Most Popular Song*, 56 J. COPYRIGHT SOC'Y U.S.A. 335 (2009), <http://ssrn.com/abstract=1111624>; Michael A. Carrier, *Copyright and Innovation: The Untold Story*, 2012 WIS. L. REV. 891 (2012); Julie E. Cohen, *Creativity and Culture in Copyright Theory*, 40 U.C. DAVIS L. REV. 1151 (2007); Peter C. DiCola, *Money From Music: Survey Evidence on Musicians' Revenue and Lessons About Copyright Incentives*, 55 ARIZ. L. REV. 1 (2013); Joseph Fishman, *Creating Around Copyright*, 128 HARV. L. REV. 1333 (2015); Daniel J. Gervais, *Transmissions of Music on the Internet: An Analysis of the Copyright Laws of Canada, France, Germany, Japan, the United Kingdom, and the United States*, 34 VAND. J. TRANSNAT'L L. 1363 (2001), <http://ssrn.com/abstract=733763>; Brad A. Greenberg, *Copyright Trolls and the Common Law*, 100 IOWA L. REV. BULL. 77 (2015); William M. Landes & Richard A. Posner, *Indefinitely Renewable Copyright*, 70 U. CHI. L. REV. 471 (2003); Jessica Litman, *Sharing and Stealing*, 27 HASTINGS COMM. & ENT. L.J. 1 (2004), <http://ssrn.com/abstract=621261>; John G. Palfrey, Urs Gasser, Miriam Simun & Rosalie Barnes, *Youth, Creativity, and Copyright in the Digital Age* (Berkman Center Research Pub. No. 2009-05, 2009), <http://ssrn.com/abstract=1552415>; Lawrence B. Solum, *The Future of Copyright*, 83 TEX. L. REV. 1137 (2005).

⁴¹ See generally Lisa J. Hedrick, *Tearing Fashion Design Protection Apart at the Seams*, 65 WASH. & LEE L. REV. 215 (2008); Randal C. Picker, *Of Pirates and Puffy Shirts: A Comment on the Piracy Paradox: Innovation and Intellectual Property in Fashion Design*, VA. L. REV. IN BRIEF (2007), <http://ssrn.com/abstract=959727>; Kal Raustiala & Christopher Jon Sprigman, *The Piracy Paradox: Innovation and Intellectual Property in Fashion Design*, 92 VA. L.

2016] SOME KEY THINGS U.S. ENTREPRENEURS NEED TO KNOW 167

patents,⁴⁴ servicemarks and trademarks,⁴⁵ trade names, and trade secrets (such as business practices, customer information, and marketing plans).⁴⁶

REV. 1687 (2006); Kevin V. Tu, *Counterfeit Fashion: The Interplay between Copyright and Trademark Law in Original Fashion Designs and Designer Knockoffs*, 18 TEX. INTELL. PROP. L.J. 419 (2010), <http://ssrn.com/abstract=1681053>.

⁴² See generally Jeffrey M. Samuels & Linda B. Samuels, *Internet Domain Names: The Uniform Dispute Resolution Policy*, 40 AM. BUS. L.J. 885 (2003); Andrew Sellars, *The In Rem Forfeiture of Copyright-Infringing Domain Names* (May 8, 2011), <http://ssrn.com/abstract=1835604>.

⁴³ See Thomas G. Field, *Copyright Protection for Perfumes*, 45 IDEA: J. L. & TECH. 19 (2004), <http://ssrn.com/abstract=573881>.

⁴⁴ See generally John R. Allison, Mark A. Lemley, Kimberly A. Moore & R. Derek Trunkey, *Valuable Patents*, 92 GEO. L.J. 435 (2004); Michael J. Burstein, *Patent Markets: A Framework for Evaluation*, 47 ARIZ. ST. L.J. (Dec. 14, 2015); Daniel Cahoy, *Breaking Patents*, 32 MICH. J. INT'L L. 461 (2011); Colleen V. Chien, *Startups and Patent Trolls*, STAN. TECH. L. REV. 461 (2014); Tammy W. Cowart, Roger Lirely & Sherry Avery, *Two Methodologies for Predicting Patent Litigation Outcomes: Logistic Regression Versus Classification Trees*, 51 AM. BUS. L.J. 843 (2014); Rochelle Cooper Dreyfuss, *Are Business Method Patents Bad for Business?*, 16 SANTA CLARA COMPUTER & HIGH TECH. L.J. 263 (2000); Anne Layne-Farrar & David S. Evans, *Software Patents and Open Source: The Battle Over Intellectual Property Rights*, VA. J. L. & TECH., 1 (2004); Roger A. Ford, *The Patent Spiral* (April 10, 2015), <http://ssrn.com/abstract=2593358>; Stuart J.H. Graham, Robert P. Merges, Pamela Samuelson & Ted M. Sichelman, *High Technology Entrepreneurs and the Patent System: Results of the 2008 Berkeley Patent Survey*, 24 BERKELEY TECH. L.J. 255 (2009); Nathaniel Grow, *Joint Patent Infringement Following Akamai*, 51 AM. BUS. L.J. 71 (2014); Clarisa Long, *Patent Signals*, 69 U. CHI. L. REV. 625 (2002); Ronald J. Mann, *Do Patents Facilitate Financing in the Software Industry?*, 83 TEX. L. REV. 961 (2005); Lynda J. Oswald, *Simplifying Multi-Actor Patent Infringement Cases Through Proper Application of Common Law Doctrine*, 51 AM. BUS. L.J. 1 (2014); Gideon Parchomovsky & Alex Stein, *Originality*, 95 VA. L. REV. 1505 (2009); Jason Schultz & Jennifer M. Urban, *Protecting Open Innovation: The Defensive Patent License as a New Approach to Patent Threats, Transaction Costs, and Tactical Disarmament*, 26 HARV. J.L. & TECH. 1 (2012), <http://ssrn.com/abstract=2040945>; Andrew W. Torrance & Bill Tomlinson, *Patents and the Regress of Useful Arts*, 10 COLUM. SCI. & TECH. L. REV. 130 (2009).

⁴⁵ See generally Stephanie M. Greene, *Sorting Out 'Fair Use' and 'Likelihood of Confusion' in Trademark Law*, 43 AM. BUS. L.J. 43 (2006).

⁴⁶ See generally John R. Allison & Lianlian Lin, *The Evolution of Chinese Attitudes Toward Property Rights in Invention and Discovery*, 20 U. PA. J. INT'L ECON. L. 735 (1999), <http://ssrn.com/abstract=222539>; Robert C. Bird, *Defending Intellectual Property Rights in the BRIC Economies* (Sept. 15, 2005), <http://ssrn.com/abstract=807844>; Jordan M. Blanke, *Vincent van Gogh, "Sweat of the Brow," and Database Protection*, 39 AM. BUS. L.J. 645 (2002); Robert G. Bone, *Trade Secrecy, Innovation, and the Requirement of Reasonable Secrecy Precautions*, in THE LAW AND THEORY OF TRADE SECRECY: A HANDBOOK OF CONTEMPORARY RESEARCH (Rochelle C. Dreyfuss & Katherine J. Strandberg, eds., Edward Elgar Press, 2010), <http://ssrn.com/abstract=1467723>; Daniel Cahoy & Robert Bird, *The Emerging BRIC Economies: Lessons from Intellectual Property Negotiation and Enforcement*, 5 N.J. TECH. & INT'L PROP. 400 (2007); Richard A. Epstein, *Trade Secrets as Private Property: Their Constitutional Protection* (U Chi. Law & Econ., Olin Working Paper No. 190, June 2003), <http://ssrn.com/abstract=421340>; Sandy Klasa, Hernan Ortiz-Molina, Matthew A. Serfling & Shweta Srinivasan, *Protection of Trade Secrets and Capital Structure Decisions* (July 15, 2015), <http://ssrn.com/abstract=2439216>; Mark A. Lemley, *The Surprising Virtues of Treating Trade Secrets as IP Rights*, 61 STAN. L. REV. 311 (2008); Josh Lerner, *Using Litigation to Understand Trade Secrets: A Preliminary Exploration* (Aug. 2006), <http://ssrn.com/abstract=922520>; Gillian L. L. Lester & Eric L. Talley, *Trade Secrets and Mutual Investments* (USC Law School, Olin Res. Paper No. 00-15, Georgetown Law & Econ. Res. Paper No. 246406, 2000), <http://ssrn.com/abstract=246406> (customer lists); Tom C. W. Lin, *Executive Trade Secrets*, 87 NOTRE DAME L. REV. 911 (2012); Jacob Loshin, *Secrets Revealed: How Magicians Protect Intellectual Property without Law* (July 25, 2007), <http://ssrn.com/abstract=1005564>; Brian J. Love & Christopher B. Seaman, *Best Mode Trade Secrets*, 15 YALE J. L. & TECH. 1, (2012); Marisa Anne Pagnattaro, *'The Google Challenge': Enforcement of Noncompete and Trade Secret Agreements for Employees Working in China*, 44 AM. BUS. L.J. 603 (2007); Marisa Anne Pagnattaro, *Protecting Trade Secrets in China: Update on Employee Disclosures and the Limitations of the Law*, 45 AM. BUS. L.J.

Article 1, section 8 of the Constitution of the United States provides that “Congress shall have power . . . to promote the progress of science and useful arts, by securing for limited times to authors and inventors the exclusive right to their respective writings and discoveries.”⁴⁷ Professors Peter Menell and Suzanne Scotchmer describe the two principal objectives of intellectual property law as: (1) promoting innovation and aesthetic creativity; and (2) protecting the integrity of the commercial IP marketplace.⁴⁸ As Professor Mark A. Lemley observes, “IP laws are deliberate government interventions in the market to try to shape how people participate in that market, encouraging new creation by rewarding it with above-market returns and discouraging imitation by imposing damages or even barring it altogether.”⁴⁹

Advances in information technology raise new IP issues.⁵⁰ For example, Professor Jack

399 (2008); Michael Risch, *Why Do We Have Trade Secrets?*, 11 MARQ. INTELL. PROP. L. REV. 1 (2007); Elizabeth A. Rowe, *When Trade Secrets Become Shackles: Fairness and The Inevitable Disclosure Doctrine*, 7 TUL. J. TECH. & INTELL. PROP. 167 (2005); Kurt M. Saunders, *Can You Keep a (Trade) Secret? - The Pennsylvania Uniform Trade Secrets Act*, 75 PA. B. ASS'N. Q. 139 (2004), <http://ssrn.com/abstract=563056>; Henry E. Smith, *Intellectual Property as Property: Delineating Entitlements in Information*, 116 YALE L.J. 1742 (2007).

⁴⁷ U.S. CONST. art. I, § 8; *but see* Lewis Hyde, *Frames from the Framers: How America's Revolutionaries Imagined Intellectual Property* (Dec. 2005), <http://ssrn.com/abstract=870073> (observing that copyright and patent were understood by the Founders to be monopolies; and unchecked monopolies were understood as social evils. Also, that IP should ultimately be an intangible equivalent of tangible res publicae, like roads, bridges, or harbors). *See also* Adam Mossoff, *Who Cares What Thomas Jefferson Thought About Patents? Reevaluating the Patent 'Privilege' in Historical Context*, 92 CORNELL L. REV. 953 (2007); Lawrence B. Solum, *Congress's Power to Promote the Progress of Science: Eldred v. Ashcroft*, 36 LOY. L.A. L. REV. 1 (2002).

⁴⁸ *See generally* Peter S. Menell & Suzanne Scotchmer, *Intellectual Property* (UC Berkeley Public Law Res. Paper No. 741724), <http://ssrn.com/abstract=741424>. *See also* Robert E. Litan et al., *Rules for Growth: Promoting Innovation and Growth Through Legal Reform* (Yale Law & Econ. Res. Paper No. 426, Stan. Law & Econ. Olin Working Paper No. 410, UC Berkeley Public Law Res. Paper No. 1757982, 2011), <http://ssrn.com/abstract=1757982>; Robert E. Thomas, *Vanquishing Copyright Pirates and Patent Trolls: The Divergent Evolution of Copyright and Patent Laws*, 43 AM. BUS. L.J. 689 (2006).

⁴⁹ *See* Mark A. Lemley, *IP and Other Regulations* (Apr. 2, 2015), <http://ssrn.com/abstract=2589278> (citing Mark A. Lemley, *Taking the Regulatory Nature of IP Seriously*, 92 TEX. L. REV. 107 (2014)). *See also* Daniel Cahoy, *Changing the Rules in the Middle of the Game: How the Prospective Application of Judicial Determinations Related to Intellectual Property can Promote Economic Efficiency*, 41 AM. BUS. L.J. 1 (2003); Jonathan Zittrain, *Internet Points of Control*, B.C. L. REV. L.J. 1 (2003); Mark A. Lemley, *The Regulatory Turn in IP*, 36 HARV. J. L. & PUB. POL'Y 109 (2013); Jonathan Zittrain, *Internet Points of Control*, 44 B.C. L. REV. 653 (2003), at <http://ssrn.com/abstract=388860>.

⁵⁰ Jonathan Zittrain, *A History of Online Gatekeeping*, 19 HARV. J.L. & TECH. 253 (2006). *See* Deven R. Desai & Gerard N. Magliocca, *Patents, Meet Napster: 3D Printing and the Digitization of Things*, 102 GEO. L.J. 1691 (2014), <http://ssrn.com/abstract=2338067>. *See also* Urs Gasser, *iTunes: How Copyright, Contract, and Technology Shape the Business of Digital Media - A Case Study* (Berkman Center for Internet & Society at Harv. Law Sch. Res. Pub. No. 2004-07, June 2004), <http://ssrn.com/abstract=556802>; Stephanie Greene, *Reconciling Napster With The SONY Decision and Recent Amendments to Copyright Law*, 39 AM. BUS. L.J. 57 (2001); F. Scott Kieff & Troy A. Paredes, *The Basics Matter: At the Periphery of Intellectual Property* (Stan. Law & Econ. Olin Working Paper No. 275, 2004), <http://ssrn.com/abstract=501142>; Mark A. Lemley, *The Economics of Improvement in Intellectual Property Law*, 75 TEX. L. REV. 989 (1997); Andrea M. Matwyshyn, *Technoconsent(s)us*, 85 WASH. U. L. REV. 529 (2007); Derek Slater, Urs Gasser, Meg Smith, Derek E. Bambauer & John G. Palfrey, *Content and Control: Assessing the Impact of Policy Choices on Potential Online Business Models in the Music and Film Industries* (Berkman Publication Series Paper No. 2005-01, 2005), <http://ssrn.com/abstract=654602>; Deborah S. Tussey, *Music at the Edge of Chaos: A Complex Systems Perspective on File Sharing*, 37 LOY. U. CHI. L.J. 147 (2005); Peter K. Yu, *From*

M. Balkin states, “The most important decisions affecting the future of freedom of speech will not occur in constitutional law; they will be decisions about technological design, legislative and administrative regulations, the formation of new business models, and the collective activities of end-users.”⁵¹ Entrepreneurs may find it advisable to require nondisclosure agreements before making disclosures about key intellectual property assets for purposes of financing, key employee recruitment, business combinations or acquisitions, or other similar purposes.⁵² The three primary forms of intellectual property protection are copyright, patent, and trademark.

Copyright

The U.S. Copyright office defines copyright as “a form of protection grounded in the U.S. Constitution and granted by law for original works of authorship fixed in a tangible medium of expression. Copyright covers both published and unpublished works.”⁵³ The law of copyright “protects original works of authorship including literary, dramatic, musical, and artistic works, such as poetry, novels, movies, songs, computer software, and architecture. Copyright does not protect facts, ideas, systems, or methods of operation, although it may protect the way these things are expressed.”⁵⁴ Copyright differs from a trademark or patent in that:

Copyright protects original works of authorship, while a patent protects inventions or discoveries. Ideas and discoveries are not protected by the copyright law, although the way in which they are expressed may be. A trademark protects words, phrases, symbols, or designs identifying the source of the goods or services of one party and distinguishing them from those of others.⁵⁵

Copyright protection is afforded “the moment it is created and fixed in a tangible form that it is perceptible either directly or with the aid of a machine or device False You will have to register, however, if you wish to bring a lawsuit for infringement of a U.S. work.”⁵⁶ In

Pirates to Partners (Episode II): Protecting Intellectual Property in Post-WTO China, 55 AM. U. L. REV. 901 (2006); Jonathan Zittrain, *A History of Online Gatekeeping*, 19 HARV. J.L. & TECH. 253 (2006); Jonathan Zittrain, *Normative Principles for Evaluating Free and Proprietary Software*, 71 U. CHI. L. REV. 265 (2004).

⁵¹ See generally Jack M. Balkin, *The Future of Free Expression in a Digital Age*, 36 PEPP. L. REV. 427 (2009). See also Richard N. Langlois, *Technological Standards, Innovation, and Essential Facilities: Toward a Schumpeterian Post-Chicago Approach* (Feb. 14, 2000), <http://ssrn.com/abstract=204069>; Bernard Reddy & David S. Evans, *Government Preferences for Promoting Open-Source Software: A Solution in Search of a Problem* (May 21, 2002), <http://ssrn.com/abstract=313202>; Siva Vaidhyanathan, *Open Source as Culture-Culture as Open Source*, OPEN SOURCE ANNUAL 2005 (Clemens Brandt ed., Berlin: Technische U., 2005), <http://ssrn.com/abstract=713044>; Jonathan Zittrain, *The Generative Internet*, 119 HARV. L. REV. 1974 (2006).

⁵² See generally Stephen M. McJohn, *Top Tens in 2012: Patent, Trademark, Copyright and Trade Secret Cases*, 11 NW. J. TECH. & INTELL. PROP. 173 (2013), <http://ssrn.com/abstract=2186675> (observing that nondisclosure agreements were held to provide less protection for claimed trade secrets than some precedent would suggest).

⁵³ See *Copyright in General*, U.S. COPYRIGHT OFFICE, <http://copyright.gov/help/faq/faq-general.html#what> (last visited July 3, 2016).

⁵⁴ *Id.*

⁵⁵ *Id.*; see also Kevin J. Hickey, *Reframing Similarity Analysis in Copyright*, 93 WASH. U. L. REV. (forthcoming), <http://ssrn.com/abstract=2587289>.

⁵⁶ U.S. COPYRIGHT OFFICE, *supra* note 53.

addition, “[r]egistered works may be eligible for statutory damages and attorney’s fees in successful litigation. Finally, if registration occurs within five years of publication, it is considered *prima facie* evidence in a court of law.”⁵⁷ The position of Register of Copyrights and the U.S. Copyright Office was “created by Congress in 1897 as a separate department of the Library of Congress.”⁵⁸

Patent

The Leahy-Smith America Invents Act (AIA),⁵⁹ signed into law by President Barack Obama on September 16, 2011, “represents the most significant reform of the Patent Act since 1952 . . . [intended to] give a boost to American companies and inventors who have suffered costly delays and unnecessary litigation, and let them focus instead on innovation and job creation.”⁶⁰ The AIA is intended to help entrepreneurs, inventors and small business owners by immediately offering:

1. a fast track option for patent processing within 12 months;
2. reducing the current patent backlog;
3. reducing litigation;
4. increasing patent quality; and
5. increasing the ability of American inventors to protect their IP abroad.⁶¹

Observing that “obtaining patent protection is vital for [many] startup companies,”⁶² Professor Patricia E. Campbell warns that certain provisions of the AIA “potentially [make] it more difficult for them to obtain patents and [cast] doubt on the validity of any patents they may receive.”⁶³ Most significantly, the AIA provides that the United States changed, effective

⁵⁷ *Id.*

⁵⁸ See *Overview of the Copyright Office*, U.S. COPYRIGHT OFFICE, <http://copyright.gov/about/> (last visited July 3, 2016).

⁵⁹ Leahy-Smith America Invents Act, Pub. L. No. 112-29, 125 Stat. 284 (2011) (codified in scattered sections of 35 U.S.C.), <http://www.gpo.gov/fdsys/pkg/PLAW-112publ29/pdf/PLAW-112publ29.pdf> (last visited July 3, 2016).

⁶⁰ Press Release, The White House, President Obama Signs America Invents Act, Overhauling the Patent System to Stimulate Economic Growth, and Announces New Steps to Help Entrepreneurs Create Jobs (Sept. 16, 2011), <https://www.whitehouse.gov/the-press-office/2011/09/16/president-obama-signs-america-invents-act-overhauling-patent-system-stim>.

⁶¹ *Id.*

⁶² See generally Patricia E. Campbell, *Coping With the America Invents Act: Patent Challenges for Startup Companies*, 8 OHIO ST. ENTREPRENEURIAL BUS. L.J. 355 (2013). See Mark A. Lemley & Dan L. Burk, *Policy Levers in Patent Law*, 89 VA. L. REV. 1575 (2003) (suggesting that economic policy and industry-specific variation should be considered when applying patent rules to specific cases).

⁶³ *Id.* (citing Virginia Bridges, *Patent Laws Change Saturday, Affecting Small Business Inventors*, NEWS OBSERVER (Mar. 11, 2013), <http://www.newsobserver.com/2013/03/11/2742358/inventors-should-move-quickly.html>); Gary Lauder, *New Patent Law Means Trouble for Tech Entrepreneurs*, FORBES (Sept. 20, 2011, 4:04 PM), <http://www.forbes.com/sites/ciocentral/2011/09/20/new-patent-law-means-trouble-for-tech-entrepreneurs/>.

2016] SOME KEY THINGS U.S. ENTREPRENEURS NEED TO KNOW 171

March 16, 2013, from a first-to-invent system to a first-to-file regime.⁶⁴ Other significant challenges to inventors include “the expanded definition of prior art and the uncertainty surrounding ‘disclosures’ and the multitude of new opportunities for third parties to challenge the issuance and validity of patents.”⁶⁵

The role of the United States Patent and Trademark Office (USPTO), an agency of the U.S. Department of Commerce, “is to grant patents for the protection of inventions and to register trademarks.”⁶⁶ The patent confers “‘the right to exclude others from making, using, offering for sale, or selling’ the invention in the United States or ‘importing’ the invention into the United States.”⁶⁷ Of significance, the actual right “granted is not the right to make, use, offer for sale, sell or import, but the right to exclude others from making, using, offering for sale, selling or importing the invention.”⁶⁸ The USPTO describes the three types of patents as follows:

- 1) **Utility patents** may be granted to anyone who invents or discovers any new and useful process, machine, article of manufacture, or composition of matter, or any new and useful improvement thereof;
- 2) **Design patents** may be granted to anyone who invents a new, original, and ornamental design for an article of manufacture; and
- 3) **Plant patents** may be granted to anyone who invents or discovers and asexually reproduces any distinct and new variety of plant.⁶⁹

Of course obtaining a patent and enforcing it are two different things. The time and expense of both initial patent prosecution and subsequent litigating of claims of patent infringement can be quite large. Accordingly, an entrepreneur should discuss with qualified patent counsel a cost-benefit analysis of both the initial patenting costs and potential enforcement costs, taking into account other possible approaches (such as, for example, reliance on trade secrets).⁷⁰

Patent Agents and Attorneys

Intellectual property practice is a uniquely specialized area of the law. The USPTO warns that application preparation “for patent and the conducting of the proceedings in the [USPTO] to obtain the patent is an undertaking requiring the knowledge of patent law and rules and Office practice and procedures, as well as knowledge of the scientific or technical matters

⁶⁴ See Leahy-Smith America Invents Act, *supra* note 59, at § 3.

⁶⁵ Campbell, *supra* note 62, at 356; see also Robin Feldman, *Patent Demands & Startup Companies: The View From The Venture Capital Community*, 16 YALE J.L. & TECH. 236 (2014) (discussing patent monetization).

⁶⁶ *General Information Concerning Patents*, U.S. PATENT & TRADEMARK OFFICE, 2 (Oct. 2014), <http://www.uspto.gov/patents-getting-started/general-information-concerning-patents>.

⁶⁷ *Id.*

⁶⁸ *Id.*

⁶⁹ *Id.*

⁷⁰ See DAVID L. BODDE, *THE INTENTIONAL ENTREPRENEUR: BRINGING TECHNOLOGY AND ENGINEERING TO THE REAL NEW ECONOMY*, ch. 8 (2004); Thomas G. Field, Jr., *IP Basics: Seeking Cost-Effective Patents*, <http://ecorner.stanford.edu/authorMaterialInfo.html?mid=1428> (last visited Dec. 3, 2015).

involved in the particular invention.”⁷¹ Moreover,

Inventors may prepare their own applications and file them in the USPTO and conduct the proceedings themselves, but unless they are familiar with these matters or study them in detail, they may get into considerable difficulty. While a patent may be obtained in many cases by persons not skilled in this work, there would be no assurance that the patent obtained would adequately protect the particular invention.

Most inventors employ the services of registered patent attorneys or patent agents. The law gives the USPTO the power to make rules and regulations governing conduct and the recognition of patent attorneys and agents to practice before the USPTO. Persons who are not recognized by the USPTO for this practice are not permitted by law to represent inventors before the USPTO. The USPTO maintains a register of attorneys and agents. To be admitted to this register, a person must comply with the regulations prescribed by the Office, which require a showing that the person is of good moral character and of good repute and that he or she has the legal, scientific, and technical qualifications necessary to render applicants for patents a valuable service. Certain of these qualifications must be demonstrated by the passing of an examination. Those admitted to the examination must have a college degree in engineering or physical science or the equivalent of such a degree.

The USPTO registers both attorneys at law and persons who are not attorneys at law. The former persons are now referred to as “patent attorneys,” and the latter persons are referred to as “patent agents.” Both patent attorneys and patent agents are permitted to prepare an application for a patent and conduct the prosecution in the USPTO. Patent agents, however, cannot conduct patent litigation in the courts or perform various services that the local jurisdiction considers as practicing law. For example, a patent agent could not draw up a contract relating to a patent, such as an assignment or a license, if the state in which he or she resides considers drafting contracts as practicing law

The USPTO cannot recommend any particular attorney or agent, or aid in the selection of an attorney or agent, as by stating, in response to inquiry that a named patent attorney, agent, or firm, is “reliable” or “capable.” The USPTO maintains a directory of registered patent attorneys and agents at <https://oedci.uspto.gov/OEDCI/...>

In employing a patent attorney or agent, the inventor executes a power of attorney, which is filed in the USPTO and made of record in the application file. When a registered attorney or agent has been appointed, the Office does not communicate with the inventor directly but conducts the correspondence with the attorney or agent

⁷¹ See *supra* note 66.

since he or she is acting for the inventor thereafter although the inventor is free to contact the USPTO concerning the status of his or her application. The inventor may remove the attorney or agent by revoking the power of attorney.⁷²

Trademark

The USPTO describes a trademark as “a word, name, symbol, or device that is used in trade with goods to indicate the source of the goods and to distinguish them from the goods of others.”⁷³ Closely related, “a servicemark is the same as a trademark except that it identifies and distinguishes the source of a service rather than a product. The terms ‘trademark’ and ‘mark’ are commonly used to refer to both trademarks and servicemarks.”⁷⁴ The purpose of a trademark is to identify for consumers the source of the product and perhaps provide some additional information about the product itself based on prior experiences or reputation.⁷⁵

Professor Jasmine Abdel-khalik observes that there are various types of trademarks, including word marks, slogans, logos, “color, sound, and trade dress,” which can include both the packaging and sometimes even the design of the product.⁷⁶ However, just because something can be a trademark does not mean that it will be one. There are a variety of limitations and prohibitions that can prevent a symbol from functioning like a trademark,⁷⁷ and consulting with an attorney can help steer a business through these limitations and prohibitions. In addition, there can be complications a business has not considered. For example, although logos are a type of trademark, they can also “have [tricky] copyright implications if you hire someone to create [or] design it.”⁷⁸

Unlike a patent, a trademark or servicemark is created as soon as it is used to sell products, goods, or services, but a business can apply for a federal registration (as long as there is prior use or a bona fide intent to use the mark for the identified goods, services, or both) and receive some additional benefits.⁷⁹ Because of the ease in creating a trademark, businesses must be particularly careful when choosing marks to avoid infringing the marks owned by others. A trademark-experienced attorney can provide a trademark clearance report to assess the risk that any mark is unavailable based on another’s use as well as assist with the registration process.

⁷² *Id.*

⁷³ *Id.* at 3.

⁷⁴ *Id.*

⁷⁵ See J. THOMAS MCCARTHY, MCCARTHY ON TRADEMARKS AND UNFAIR COMPETITION §§ 2:3, 2:5 (4th ed. 2015).

⁷⁶ Email from Jasmine C. Abdel-khalik, Associate Professor, UMKC School of Law (May 27, 2015) (on file with authors) [hereinafter Abdel-khalik]; see also MCCARTHY, *supra* note 75, at §§ 7:9, 7:19, 7:24, 7:26, 7:33, 7:39, 7:54, 7:106–7:108.

⁷⁷ See, e.g., MCCARTHY, *supra* note 75, at §§ 7:63, 12:1, 13:1, 14:1, 15:2, 19:75 (discussing, to name a few: functionality, genericness, personal names, geographic terms, terms that need secondary meaning, and statutory bars to federal registration).

⁷⁸ Abdel-khalik, *supra* note 76.

⁷⁹ *Id.*; MCCARTHY, *supra* note 75, at §§ 16:1, 19:1.25.

PRINCIPAL CHOICE OF ENTITY CONSIDERATIONS

Choice-of-entity analysis can be generally separated into questions of (1) liability management, (2) agency authority, and (3) capital structure, including tax considerations. Many law school graduates should be familiar with this multi-layered analysis from courses in business associations or organizations and taxation of business enterprises. What is commonly referred to as “choice of entity” essentially consists of three choices: what basic form of entity is wanted, under what jurisdiction’s laws should it be formed, and what tax classification is desired for it for federal and state tax purposes?⁸⁰

Corporations and other entity types, such as the limited liability company (LLC), are generally creatures of state law. A corporation created under the laws of Delaware will be subject to different governance, case law regime, and regulatory schematic than a corporate entity organized under the laws of Florida or Texas. Because choice of entity is legally intensive, the issue should not be undertaken without the guidance of an experienced attorney, preferably one who practices in the jurisdiction where the start-up company will be domiciled and will conduct the bulk of its business. However, in some cases an entrepreneur may find, with advice of qualified counsel, that he or she wants to form their company under the law of a state other than the venture’s principal business location. That approach is made possible by (i) the ability to form a company in a state and then register it to do business in the other states in which it will conduct business, and (ii) the “internal affairs” doctrine, which generally allows the law of the entity’s formation to govern matters pertaining to the internal relationships among the company and its owners and management, and matters regarding the statutory shielding of certain types of owners from personal liability for company obligations.⁸¹

Each of the following types of business entity offers its own advantages and disadvantages (and some may not be available in all jurisdictions): sole proprietorship, general partnership, limited liability partnership, limited partnership, limited liability limited partnership, limited liability company, certain business trusts (e.g. Real Estate Investment Trust, etc.), and corporation.⁸²

⁸⁰ While many states follow the federal tax classification of a business entity for income tax purposes, some do not, so a state-by-state analysis is needed for a complete picture. *See, e.g.*, C. Andrew Lafond & Jeffrey J. Schrader, *Multistate Tax Considerations for S Corporations*, J. ACCT. (Jan. 31, 2011), <http://www.journalofaccountancy.com/issues/2011/feb/20103307.html>.

⁸¹ *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 302 (1971); FRANKLIN GEVURTZ, *BUSINESS PLANNING* 101–02 (5th ed. 2015); ROBERT W. HAMILTON, JONATHAN R. MACEY, & DOUGLAS K. MOLL, *THE LAW OF BUS. ORG.*, 156 (12th ed. 2014).

⁸² There are a multitude of publications with in-depth discussion of tax and non-tax considerations in making choice of entity determinations. *See, e.g.*, BAGLEY & DAUCHY, *supra* note 9, at ch. 4 (“Deciding Whether to Incorporate”); DRAKE, *supra* note 9, at ch. 3 (“The Choice of Entity Challenge”); Byron F. Egan, *Choice of Entity Decision Tree After Margin Tax and Texas Business Organizations Code*, 42 TEX. J. BUS. L. 171 (2007); Byron F. Egan, *Choice of Entity Alternatives*, 39 TEX. J. BUS. L. 379 (2004); WILLIAM P. STRENG, *CHOICE OF ENTITY*, *Blomberg/BNA Tax Management Portfolio 700-3rd*; Stephanie M. Greene, *Improving Internal Governance in Unincorporated Business Entities*, 46 AM. BUS. L.J. v (2009) (sole proprietorship); Myron T. Steele, *Freedom of Contract and Default Contractual Duties in Delaware Limited Partnerships and Limited Liability Companies*, 46 AM. BUS. L.J. 221 (2009); Sandra K. Miller, *Fiduciary Duties in the LLC: Mandatory Core Duties to Protect the Interests of Others Beyond the Contracting Parties*, 46 AM. BUS. L.J. 243 (2009); Larry A. DiMatteo, *Policing Limited Liability Companies Under Contract Law*, 46 AM. BUS. L.J. 279 (2009).

Liability Considerations

A primary goal of entity choice is to limit the personal liability of individuals involved in the enterprise. For example, a sole proprietor is personally liable for wrongful acts and contracts entered, as are partners in regular (sometimes called “general”) partnerships and general partners in limited partnerships—whereas shareholders of a corporation, limited partners in limited partnerships, all partners in limited liability partnership or limited liability limited partnership, and members of a LLC are generally not personally liable for obligations of the entity.⁸³ However, the “liability shield” generally available to owners in those latter categories is not without exceptions.

First, particular statutory provisions may impose personal liability on owners for some specific types of obligations.⁸⁴ Second, courts have developed the doctrine of “piercing the corporate veil” (which has been applied to not just corporations, but also to unincorporated entities, such as limited liability companies), where the facts and circumstances indicate the company was formed or maintained in a flimsy or deceptive manner, and one or more of the company owners should be held personally liable for company obligations.⁸⁵ Third, even if the company is properly formed and well-maintained in a manner providing owners with a good shield from personal liability, a savvy lender, lessor, or other would-be creditor of a company may insist on a personal guarantee from one or more of the owners as a condition to making the loan, lease, or other contract with the company. In addition, entrepreneurs looking to start a company need to understand that even if none of those exceptions apply, they can still be personally liable for their own wrongdoing—in other words, the liability shields offered by various types of business entities are designed to relieve an owner from vicarious personal liability for *company* obligations, not for the owner’s own direct obligations.

Agency Authority

Entrepreneurs forming a business entity should be concerned with who in the organization may have authority to bind the company to contracts. While a business entity can create “agents” to act for it by agreement, it is also the case that the type of entity formed may *automatically* create agents by statute under the applicable business organizations law. For example, all partners in a regular partnership are typically by statute agents with authority to bind the partnership to contracts in the usual course of business.⁸⁶ Moreover, each partner has “apparent authority” to conduct such ordinary business—meaning that, for example, even if the partners have agreed among themselves that no partner is to commit the partnership to a contract of a certain size or duration without the prior approval of other partners, a partner ignoring that restriction and signing such a contract without such approval on behalf of the

⁸³ See, e.g., GEVURTZ, *supra* note 81, at 51–53; HAMILTON, ET AL., *supra* note 81, at 3–5, 1115, 1177–97, 1199.

⁸⁴ See, e.g., HAMILTON, ET AL., *supra* note 81, at 255 (discussing possible liability under environmental laws); *Employment Taxes and the Trust Fund Recovery Penalty (TFRP)*, INTERNAL REVENUE SERVICE, <http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Employment-Taxes-and-the-Trust-Fund-Recovery-Penalty-TFRP> (last visited July 3, 2016)(discussing “responsible person” liability for trust fund and payroll taxes).

⁸⁵ See generally GEVURTZ, *supra* note 81, at 50; HAMILTON, ET AL., *supra* note 81, at 213–57, 1250–57.

⁸⁶ See UNIF. P’SHIP ACT 1914 § 9; REV. UNIF. P’SHIP ACT § 301 (1997).

partnership may well have bound the partnership to the contract. The third-party creditor is generally able to enforce the contract unless either (i) the creditor knew of the approval restriction, or (ii) the contract is of a type outside of the usual course of the partnership's business.⁸⁷ If being forced to honor the contract causes damage to the partnership, the other partners can sue the "loose cannon" who ignored the approval restriction. But what if that wrongdoer does not have enough assets to cover the damages he or she caused by exercising their "apparent authority"?

That kind of agency authority is generally granted by statute to every partner in a regular partnership or limited liability partnership, to every "general partner" in a limited partnership or limited liability limited partnership, to every member in a "member-managed" limited liability company, and to every "manager" in a manager-managed limited liability company.⁸⁸ In contrast, state business organizations statutes generally do not grant such agency authority to limited partners, to members of a manager-managed limited liability company who are not designated "managers," or to shareholders in a corporation. So, once again, it is important for entrepreneurs forming a business entity to get qualified legal counsel to help them take this agency issue into account in the multi-factored choice of entity analysis.

Capital Structure Tax Considerations

In addition to liability and agency considerations, another primary goal of business entity selection will be to settle on a structure that minimizes tax liability, while providing a legal form most conducive to raising needed capital. Relevant considerations will include, but not be limited to, the following: (i) anticipated amount of capital needed and likely sources, (ii) number of individuals involved in managing the business, and (iii) number of individuals contributing capital and whether they are natural persons or non-natural persons.

Some investors may actually be motivated to invest in a start-up in anticipation of likely losses to be incurred during the early operating history of the enterprise. In that case, or for other tax reasons,⁸⁹ they may be most interested in a "pass-through entity" for tax purposes, at least in the early stages of their venture. That means a tax status under which the entity itself does not pay income tax, but rather the owners pay tax on their shares of the entity's income and are— allocated their share of the entity's tax deductions and tax credits.⁹⁰ For many businesses, that will involve determining whether "partnership" or "S corporation" tax status is desired, as opposed to a "C corporation," in which the corporation pays tax on its taxable

⁸⁷ *Id.*

⁸⁸ See, e.g., MO. REV. STAT. § 358.090 (West 2016) (addressing partners in regular partnerships and limited liability partnerships); *Id.* § 359.251.1 (addressing general partners in limited partnerships and limited liability partnerships); *Id.* § 347.065 (addressing members in member-managed limited liability companies and managers in manager-managed limited liability companies).

⁸⁹ This includes avoiding double taxation (i.e., at both the company and owner level) of earnings, or if partnership taxation applies, having the ability to, subject to certain exceptions, make distributions of appreciated property (i.e., property with fair market value in excess of tax basis) on a tax-deferred basis. See generally GEVURTZ, *supra* note 81, at 58–80; WILLIAM S. MCKEE ET AL., FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS, ch. 1, 19 (2015).

⁹⁰ See generally HAMILTON, ET AL., *supra* note 81, at 6–14.

income, and shareholders generally pay tax on the dividends paid to them.⁹¹ Importantly, not all entities will be eligible for partnership or S corporation tax status, making it, again, important to get qualified legal counsel to explain the options and requirements, as well as the opportunities to change tax status later in the life of the venture (and the tax consequences of such changes).⁹²

A detailed comparison of partnership taxation to S corporation taxation is beyond the scope of this article, but a few key points merit mention here. First, the entrepreneur should understand that S corporations pose some pretty substantial capital structure limitations, in that they are limited to having no more than 100 shareholders, to (generally) not having any shareholders who are not human beings legally resident in the U.S. (so it generally cannot have business entities as owners), and to not having more than one class of stock in terms of distribution rights (so it cannot have preferred and common equity).⁹³ Also, the company founders need to realize that in a pass-through entity (partnership or S corporation) the owners pay tax on their shares of the entity's taxable income *whether or not they have received corresponding distributions*. Further complexities include the effects of company liabilities on the ability of owners to claim tax losses generated by the entity.⁹⁴

In addition, there can be important tax consequences associated with how owners acquire their equity interests in the business entity. For example, partnership taxation has some important differences from S or C corporations when an owner is acquiring equity in exchange for a contribution of property with a fair market value in excess of the owner's tax basis in the property, especially when the property has liabilities associated with it.⁹⁵ It is critical that the entrepreneur understand the tax implications of such property transfers. Similarly, they need to understand the tax aspects of getting equity in exchange for services or promises associated with services. Many start-up entrepreneurs fall into the trap of not understanding the tax consequences of issuing equity interests in a venture to service providers.⁹⁶ Included here is the potential importance of a timely "Section 83(b) election" with respect to non-vested equity issued in connection with the performance of services.⁹⁷ Getting qualified tax counsel involved in capital structure planning *before* any offers or promises are made is clearly the best way to go.

RAISING CAPITAL IN COMPLIANCE WITH SECURITIES LAWS

A start-up is inherently a legal endeavor. Early dollars invested to obtain solid legal advice and planning are invaluable and can save future resources by reducing the likelihood of costly, time-consuming efforts required to correct oversights and inadvertent mistakes made during the organizational business planning phase. Even worse, a naïve, well-meaning (but unlawful)

⁹¹ *Id.*

⁹² See, e.g., GEVURTZ, *supra* note 81, at 58–59, 74–76; HAMILTON, ET AL., *supra* note 81, at 6–14; MCKEE ET AL., *supra* note 89, at § 3.06.

⁹³ 26 U.S.C. § 1361 (West 2012).

⁹⁴ See GEVURTZ, *supra* note 81, at 77–78; MCKEE ET AL., *supra* note 89, at § 7.02.

⁹⁵ See GEVURTZ, *supra* note 81, at 336–37, 341–42, 351–52.

⁹⁶ See MCKEE ET AL., *supra* note 89, at ch. 5.

⁹⁷ 26 U.S.C. § 83(b).

solicitation or sale of securities not in compliance with federal and state securities laws may subject those involved to civil and criminal penalties.⁹⁸

We will present below issues regarding the definition of a “security” for key federal securities laws purposes and briefly describe equity and debt offerings to set the stage for our discussion of various types of early stage capital. The definition of “security” is quite important because if an offering of securities is to occur then it must either be registered (an expensive and time-consuming process) or demonstrated to be exempt from registration under federal and state securities regulations.⁹⁹ Complicating matters, while there is generally substantial overlap in the definitions, some states define “security” somewhat differently than federal securities law.¹⁰⁰ Again, in navigating all the requirements to avoid costly violations, skilled and experienced legal advice is not a luxury but a necessity.

What Is an Equity Security?

The term “security” is defined in Section 2(a)(1) of the Securities Act of 1933 (Securities Act) and Section 3(a)(10) of the Securities Exchange Act of 1934 (Exchange Act).¹⁰¹ Even though stock is included in the definition of a security, the mere labeling of an investment as “stock” does not necessarily mean that it conforms to the definition of “security” for purpose of the Securities Act or Exchange Act. There are certain characteristics that are common features of stock, which include: (1) the right to receive “dividends contingent upon an apportionment of profits,,” (2) negotiability, (3) the ability to be pledged or hypothecated, (4) voting rights in proportion to the number of shares owned, and (5) the ability to appreciate in value.¹⁰²

The term “investment contract” is also included in the definition and is also considered a security.¹⁰³ “Investment contract” is a broad term that has been used to analyze a variety of investment instruments, such as unincorporated entities like partnerships or limited liability companies, to determine whether or not those instruments are securities within the meaning of

⁹⁸ See generally LINDA CHATMAN THOMSEN, INT’L INST. FOR SEC. MKT. DEV., SEC. & EXCH. COMM’N, https://www.sec.gov/about/offices/oia/oia_enforce/overviewenfor.pdf; MARC I. STEINBERG, SECURITIES REGULATION (6th ed. 2013); Lawrence J. Trautman & George Michaely, *The SEC & The Internet: Regulating the Web of Deceit*, 68 CONSUMER FIN. L.Q. REP. 262 (2014), <http://www.ssrn.com/abstract=1951148>.

⁹⁹ Securities Act of 1933 §5(a), 15 U.S.C. § 77b(a)(1)(West 2015); see also MO. REV. STAT. §§ 301.1–409.3 (West 2015); FLA. STAT. § 517.07 (West 2016). For general information about state securities laws see *State Securities Regulators*, SEC.GOV, <http://www.sec.gov/answers/statesecreg.htm> (last visited July 3, 2016) and N. AM. SEC. ADMIN. ASS’N, <http://www.nasaa.org/> (last visited July 3, 2016). There are many publications addressing the securities regulations context of raising capital from various sources for start-up businesses in the U.S. See, e.g., BAGLEY & DAUCHY, *supra* note 9, at ch. 7 (“Raising Money and Securities Regulation”); DRAKE, *supra* note 9, at 135–77.

¹⁰⁰ See generally THOMAS LEE HAZEN, FEDERAL SECURITIES LAWS, 6 (3rd ed. 2011); *Blue sky law*, WEX LEGAL DICTIONARY, https://www.law.cornell.edu/wex/blue_sky_law (last visited July 3, 2016).

¹⁰¹ Securities Act of 1933 §2(a)(1), 15 U.S.C. § 77b(a)(1); Securities Exchange Act of 1934 § 3(a)(1), 15 U.S.C. §78c(a)(10); see also Stephen G. Christianson, *Proof of a “Security” under Federal and State Statutes*, 22 Am. Jur. Proof of Facts 3d 485 (2013).

¹⁰² United Hous. Found., Inc. v. Forman, 421 U.S. 837 (1975).

¹⁰³ Securities Act of 1933 §2(a)(1), 15 U.S.C. § 77b(a)(1).

the Securities Act. The traditional test for an investment contract—the “Howey test”—is: (1) an investment of money, (2) in a “common enterprise,” and, (3) with an expectation that profits will be derived “solely” through the efforts of others.¹⁰⁴

Debt

Securities may come in the form of equity or debt. Notes and other forms of debt can be considered securities.¹⁰⁵ If a corporation, limited liability company, or other business entity proposes to use debt to raise capital, the registration (or established exemption) requirements under the Securities Act will apply if the debt instrument constitutes a security.¹⁰⁶ The test, more commonly referred to as the “family resemblance test,” takes into consideration four factors: (1) the motivation of the parties, (2) plan of distribution, (3) expectations of the public, and (4) whether or not there is another applicable regulatory scheme that may reduce the risk of the investment.¹⁰⁷ When the investment involves a return of both principal and interest, the presumption is that the note may be a security, but one of the other factors may influence the analysis.¹⁰⁸ Public perception determines whether the third factor is satisfied.¹⁰⁹ The final factor is whether there is another applicable regulatory scheme (such as banking laws under the Gramm Leach Bliley Act or the regulation of employee retirement income under ERISA) that may reduce the risk of the investment.¹¹⁰

Again, the initial significance of finding that a security is being offered or sold means that the security will need to be registered on the federal level and also registered under state law in every state where an offer is made or the security is sold, unless particular exemptions from registration apply.¹¹¹ Registration is a costly process and subjects the issuer to even more possible liability. In order to avoid registration, many issuers will seek an exemption from registration. However, even if an exemption applies, there is still potential issuer liability for securities fraud.¹¹²

¹⁰⁴ SEC v. W.J. Howey Co., 328 U.S. 298 (1946). In the 1946 case, the U.S. Supreme Court shed light on the definition of a “security.” *Id.* In a case that involved land contracts for orange trees, the Court determined that a security included any scheme that involved an “an investment of money in a common enterprise with profits to come solely from the efforts of others.” *Id.* When applied to unincorporated entities, the key issue is often whether profits are to be derived solely from the efforts of the investor or whether the investor passively invests in the business. The determination of whether the investor is passive will depend on the facts and circumstances of each situation. *See* Miriam R. Albert, *The Howey Test Turns 64: Are Courts Grading This Test on a Curve?*, 2 WM. & MARY BUS. L. REV. 1 (2011).

¹⁰⁵ *Supra* note 103.

¹⁰⁶ *Reves v. Ernst & Young*, 494 U.S. 56 (1990).

¹⁰⁷ *Id.*

¹⁰⁸ *Id.*

¹⁰⁹ *Id.*

¹¹⁰ *Id.* at 66.

¹¹¹ *See supra* note 99 and accompanying text.

¹¹² *See, e.g.*, Preamble to the SEC’s Regulation D at 17 C.F.R. § 230.500(a) (“Regulation D relates to transactions exempted from the registration requirements of section 5 of the Securities Act of 1933 (the Act) (15 U.S.C. § 77a et seq., as amended). Such transactions are not exempt from the antifraud, civil liability, or other provisions of the federal securities laws.”).

The Reg. D Offering

When the SEC adopted Regulation D (Reg. D), it provided a relatively clear and viable path to exempt small and private offerings from the federal registration requirement.¹¹³ Reg. D consists of three different “issuer” exemptions: Rule 504, Rule 505, and Rule 506.¹¹⁴ While the three exemptions are subject to some common requirements and restrictions, each has some unique limitations to its availability. Reliance on Reg. D alone neither obviates the need to comply with any applicable state laws that relate to the offer or sale of securities nor voids liability under the antifraud laws.¹¹⁵ While those who appropriately rely on and satisfy the condition of a Reg. D exemption do not have to register their securities, they must provide a notice filing to the SEC on “Form D” within 15 days of the first sale.¹¹⁶

Rule 504:

Rule 504 provides an exemption from federal registration for offerings up to \$1 million in a twelve-month period.¹¹⁷ This includes all securities sold twelve months before the start of the targeted offering period.¹¹⁸ The issuer must take steps to ensure that the securities acquired are not resold.¹¹⁹ A Rule 504 offering neither limits the number of purchasers nor requires that purchasers have a certain net worth or possess a certain level of business sophistication.¹²⁰ In addition, there are no federal-level disclosure requirements.¹²¹ The issuer is prohibited from generally soliciting or advertising the offering,¹²² except those solicitation and resale restrictions do not apply if the issuer, as part of state registration requirements, publicly files and delivers substantive disclosure documents to investors before the sale of securities.¹²³ Because the securities issued under Rule 504 are not “covered securities” under section 18 of the Securities Act, an exemption under Rule 504 does not preempt state regulation.¹²⁴

Rule 505:

Rule 505 exempts offerings up to \$5 million, and included in this limit is the sale of all

¹¹³ See 17 C.F.R. §§ 230.501–230.508. The rules were adopted in Revisions of Certain Exemptions from Registration for Transactions Involving Limited Offers and Sales, Securities Act Release No. 6389, 47 Fed. Reg. 11251 (Mar. 16, 1982) (codified at 17 C.F.R. pts. 230, 239). Regulation D consists of Rules 501 through 508. Rules 501 through 503 and Rules 507 through 508 are general rules of support for the exemptions found in Rules 504 through 506.

¹¹⁴ See e.g., Edan Burkett, *A Crowdfunding Exemption? Online Investment Crowdfunding and U.S. Securities Regulation*, 13 TENN. J. BUS. L. 63, 88 (2011).

¹¹⁵ 17 C.F.R. §§ 230.500(a)–(b), 230.504(b)(1)(ii).

¹¹⁶ *Id.* § 230.503.

¹¹⁷ *Id.* § 230.504(b)(2).

¹¹⁸ *Id.* § 230.504(b)(2), n.1, n.2..

¹¹⁹ *Id.* § 230.502(d).

¹²⁰ *Id.* § 230.504.

¹²¹ *Id.* §§ 230.504, 230.502(b)(1).

¹²² *Id.* §§ 230.504(b)(1), 230.502(c).

¹²³ *Id.* § 230.504(b)(i)–(ii).

¹²⁴ *Id.* § 230.500(b)(1); see also GEVURTZ, *supra* note 81, at 654–55.

2016] SOME KEY THINGS U.S. ENTREPRENEURS NEED TO KNOW 181

securities sold twelve months before and during the offering period.¹²⁵ While an issuer may sell to an unlimited number of “accredited” investors, the number of non-accredited investors is limited to thirty-five.¹²⁶ Even though the rule does not require non-accredited investors to be financially sophisticated, the issuer must disclose to all non-accredited investors investment information consisting of financial statements certified by an independent public accountant and other written information that is material to the offering.¹²⁷ General solicitation and general advertising are also prohibited,¹²⁸ and the issuer must take steps to prevent any public resale of the securities.¹²⁹ If within the last five years the issuer has been involved in any securities law violations, then that issuer is disqualified from the Rule 505 exemption.¹³⁰ These provisions also apply to any director, officer, or owner with 10 percent or more of any class of security.¹³¹ This criterion highlights the importance of knowing and understanding the criminal and civil backgrounds of all the parties involved in the venture because it may impact the availability of some exemptions. Similar to Rule 504, state regulation is not preempted by the Rule 505 exemption.¹³²

Rule 506:

Under Rule 506, there is no limit on the dollar amount of the offering.¹³³ An unlimited number of accredited investors is permitted, and up to 35 non-accredited investors are permitted.¹³⁴ In addition, in a Rule 506 offering, each non-accredited investor must, individually or through a qualified purchaser representative, have sufficient business knowledge so he or she is capable of evaluating the risks of a potential investment.¹³⁵ As with Rule 505, specified disclosures must be made to each non-accredited investor,¹³⁶ and the issuer must take steps to ensure the securities acquired are not immediately resold.¹³⁷ The offering cannot be integrated with any other offers made within six months of the target offering.¹³⁸ There are also prohibitions on directors, executive officers, or other participants with 20

¹²⁵ *Id.* § 230.505(b)(2)(i).

¹²⁶ *Id.* § 230.505(b)(2)(ii). Accredited investors commonly tend to include an individual with an income in excess of \$200,000 in each of the past two years or joint income with a spouse in excess of \$300,000, (2) an individual with a net worth that exceed \$1 million, excluding their primary residence, or/and? (3) a business entity or trust not formed with the specific purpose of acquiring securities with total assets of \$5 million. There are other criteria, which one could meet to be considered an accredited investor, including for example individual who is a director, general partner, or “executive officer” of the issuer. *See* 17 C.F.R. § 230.501(a).

¹²⁷ 17 C.F.R. § 230.502(b)(2)(B). The issuer is not required to make the Rule 502(b)(2) disclosures to “accredited” investors, but a note under 17 C.F.R. § 230.502(b) suggests that “it should consider providing such information to accredited investors as well, in view of the anti-fraud provisions of the federal securities laws.” *Id.*

¹²⁸ 17 C.F.R. §§ 230.505(b), 230.502(c).

¹²⁹ *Id.* §§ 230.505(b), 230.502(d).

¹³⁰ *See id.* §§ 230.505(b)(2)(iii), 230.262.

¹³¹ *Id.* The SEC recently adopted similar provisions for Rule 506.

¹³² *Id.* § 230.500(b).

¹³³ *Id.* § 230.506.

¹³⁴ *Id.* §§ 230.506(b)(2)(i), 230.506(c)(2)(i).

¹³⁵ *Id.* §§ 230.506(b)(2)(ii), 230.501(a).

¹³⁶ *Id.* §§ 230.506(b)(1), 230.502(b).

¹³⁷ *Id.* §§ 230.506(b)(1), 230.502(d).

¹³⁸ *Id.* § 230.502(a).

percent or more beneficial ownership who have been convicted of a felony or misdemeanor within the last ten years in connection with the purchase or sale of a security.¹³⁹ There is a ban on general solicitation and general advertising,¹⁴⁰ though the Jumpstart Our Business Startups (JOBS) Act of 2012 and subsequently issued SEC rules lifted the ban for otherwise qualifying Rule 506 offerings in which all purchasers are accredited (or reasonably believed to be) if the issuer takes reasonable steps to verify this fact.¹⁴¹ While that limited relief from the ban on general solicitation and advertising for Rule 506 offerings with only accredited investors is sometimes referred to as a type of “crowdfunding,” it is not the same as the recently implemented “crowdfunding exemption” for certain offerings up to \$1 million discussed below.¹⁴²

Another reason Rule 506 is very important to entrepreneurs who seek to minimize expenses is because it is the only rule under Regulation D that also preempts state substantive securities regulation.¹⁴³ Even though the issuer is exempt from blue sky registration requirements, nothing in the rule shields the issuer from subsequent litigation by a state regulatory agency for securities fraud, nor does it exempt the issuer from paying any required fees or making any required notice filings.¹⁴⁴

Other Exemptions from Registration: Regulation A and Intrastate Offerings

The intrastate exemption is reserved for issuers who offer or sell securities only in the state where the issuer is incorporated.¹⁴⁵ There are three basic requirements to qualify for this exemption. The issuer must be incorporated or have its principal place of business in the state where it offers the securities, carry out a significant amount of its business in the target state, and make offers and sales only to residents of that state. Unfortunately, the restriction to a single state impacts any broad-based search for capital because it only takes one offer out of state (even if it does not result in a sale) to nullify the exemption.¹⁴⁶ Even though Section 3(a)(11) of the Securities Act of 1933 provides an exemption from federal regulation, state regulations may still apply.¹⁴⁷

In addition to the intrastate exemption, there is also Regulation A, for which the SEC recently adopted new rules.¹⁴⁸ Issuers can avoid full registration by conducting a simplified

¹³⁹ *Id.* § 230.506(d)(i).

¹⁴⁰ *Id.* §§ 230.506(b)(1), 230.502(c).

¹⁴¹ Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, 78 Fed. Reg. 44771 (July 24, 2013) (to be codified at 17 C.F.R. pt. 230, 239, and 242).

¹⁴² *See infra* note 190 and accompanying text.

¹⁴³ *See* Securities Act of 1933 §18(b)(4)(E), 15 U.S.C. §77r(b)(4)(E). *See also*, Rutherford B. Campbell, Jr., *The Wreck of Regulation D: The Unintended (and Bad) Outcomes for the SEC's Crown Jewel Exemptions*, 7 OHIO ST. ENTREPRENEURIAL BUS. L.J. 287, 287–316 (2012).

¹⁴⁴ Some states may continue to impose certain filing obligations. As a result, the issuer may be required to file a copy of its Form D with state regulators.

¹⁴⁵ Securities Act of 1933, ch. 38, § 3(a)(11), 48 Stat. 74 (codified as amended at 15 U.S.C. § 77c(a)(11)(2012)).

¹⁴⁶ *Id.*

¹⁴⁷ *Id.*

¹⁴⁸ Amendments for Small and Additional Issues Exemptions under the Securities Act, 80 Fed. Reg. 21806 (Apr. 20, 2015) (to be codified at 17 C.F.R. pts. 200, 230, 232, 239, 240, 249, and 260).

mini-registration process, but the exemption has now been expanded into two tiers.¹⁴⁹ Issuers may raise up to \$20 million in a Tier 1 offering and, with more extensive financial disclosure, up to \$50 million in a Tier 2 offering.¹⁵⁰ Under Regulation A, the SEC has evolved its position about solicitation, and allows the issuer to solicit interest in the offering prior to filing any offering statement.¹⁵¹ State registration is preempted for Tier 2 offerings, but still required for Tier 1 offerings.¹⁵² Prior to the JOBS Act, Regulation A offerings were rarely used. Some attribute this to the impact of state blue sky laws,¹⁵³ while others believe the \$5 million offering limit was too low.¹⁵⁴ It remains to be seen whether the new regulations adopted by the SEC on March 25, 2015 will increase the number of Regulation A offerings.

Private Company vs. Public Platform

Few seed-stage enterprises will achieve the success and gain the critical mass necessary to justify the expense of a registered public offering. However, planning for such an eventuality seems prudent, even at the embryo stage. Enterprises with more than 2,000 shareholders of record (or 500 that are not accredited investors) and assets of more than \$10 million are subject to the periodic reporting requirements under the Exchange Act.¹⁵⁵ With rare exceptions, all start-ups will begin life as private entities with just a few equity owners, and, if they are successful, usually spend at least a few years in a non-public mode (even if well-funded from institutional venture sources).

The benefits of being a publicly-traded company include access to securities markets to raise capital and a liquidity event for early-venture investors and key management. Disadvantages of public share ownership include the substantial expenses for legal, accounting, and regulatory compliance, additional corporate governance infrastructure expenses, including expenses associated with board committee oversight and the retention of necessary consultants and more transparency regarding corporate activities. The extra expenses can easily amount to hundreds of thousands of dollars annually, and disproportionately, will be a greater percentage of revenues for smaller enterprises.¹⁵⁶

Skilled, Experienced Legal and Accounting Advice is a Necessity

We have already seen that raising start-up capital through the issuance of securities is a legally intensive endeavor. Compliance with federal and state securities laws requires the skillful guidance of a lawyer familiar with this specific area of law. Not every attorney will be well-versed in this niche area of practice.

¹⁴⁹ *Id.* at 21807.

¹⁵⁰ *Id.*

¹⁵¹ *Id.* at 21808.

¹⁵² *Id.* at 21806; Jumpstart Our Business Startups Act, H.R. 3606, 112th Cong. § 401(b) (2012).

¹⁵³ See Campbell, *supra* note 143, at 305.

¹⁵⁴ See U.S. House of Representatives, Financial Services Committee, *Regulation A Reform in JOBS Act a "Game Changer" for Small Business* (Jun. 27, 2012), <http://financialservices.house.gov/blog/?postid=301209>.

¹⁵⁵ Securities Exchange Act of 1934, ch. 404, § 12(g), 48 Stat. 881 (codified as amended at 15 U.S.C. § 78l(g)(2015)); 17 C.F.R. §§ 240.12g-1–12g5-2 (2015).

¹⁵⁶ See generally GEVURTZ, *supra* note 81, at 562–63; See also Daniel L. Goelzer, Remarks before the PCAOB Forum on Auditing in the Small Business Environment, Fort Lauderdale, Florida (Feb. 27, 2006).

Audited financial statements and guidance with respect to required financial statement disclosures will also require coordination with and retention of a public accounting firm that routinely deals in securities transaction matters. Like law, the public accounting profession is often difficult for non-practitioners to understand. The Public Company Accounting Oversight Board (PCAOB) reports registering 1,600 accounting firms.¹⁵⁷ PCAOB board member Daniel L. Goelzer observed during 2006 that 1,600 “is a far higher number than we originally anticipated, and it reflects the breadth of the public company audit practice in this country. However, in terms of concentration, a very high percentage of the total public company market capitalization is audited by only a handful of firms.”¹⁵⁸ Moreover, “a 2004 GAO report found that just four firms audit nearly 99 percent of the revenues of all SEC registered companies.”¹⁵⁹ Although an early-stage enterprise may not need to incur the expense of hiring one of the largest accounting firms, just as in the case of finding appropriate legal guidance, not every local accounting firm will be experienced or staffed to provide the services one needs.

SOURCES OF EARLY STAGE CAPITAL

Perhaps no activity is as legally intensive as the effort by individuals or an enterprise to raise capital. Professors William R. Kerr and Ramana Nanda observe that “[f]inancing constraints are one of the biggest concerns impacting potential entrepreneurs . . .”¹⁶⁰ Sources of capital for small companies will vary based on the stage of development (seed stage, early stage before proof of concept, post-break-even, etc.) and the relative attractiveness to investors of the particular industry sector (healthcare, clean energy, biotech, pharmaceuticals, social media, etc.). Different sources will be available based upon these and other criteria. In its most simplified form, these available investors have been separated into the following categories: friends and family, angel investors, traditional commercial banks and other sources of debt or collateralized financing, Small Business Investment Companies (SBIC), institutional venture capital sources, investment banks, and franchising. Also discussed are the potential funding opportunities available by crowdfunding efforts.

Friends and Family

Most start-ups are financed initially by the entrepreneur with funds from family and friends. Because of the high risk of failure of any new business, the cost to the enterprise of financing should decrease as the perceived risk of failure decreases. It is at the very beginning, with little more than an idea, unproven concept or partial business plan that any business enterprise is most risky. Since data indicates that well over 90% of all new businesses will fail within five years, many aspiring entrepreneurs will have no choice but to fund their endeavor

¹⁵⁷ See generally Goelzer, *supra* note 156.

¹⁵⁸ *Id.*

¹⁵⁹ *Id.* See also Robert A. Prentice, *The Case for Educating Legally-Aware Accountants*, 38 AM. BUS. L.J. 597 (2001).

¹⁶⁰ William R. Kerr & Ramana Nanda, *Financing Constraints and Entrepreneurship* (Harv. Bus. Sch. Entrepreneurial Mgmt., Working Paper 10-013, 2009), <http://ssrn.com/abstract=1447503>; see also Ramana Nanda & Matthew Rhodes-Kropf, *Financing Risk and Innovation* (Harv. Bus. Sch. Entrepreneurial Mgmt., Working Paper No. 11-013, 2014), <http://ssrn.com/abstract=1657937>.

from personal funds, credit cards, and personally secured loans.¹⁶¹

“Angel” Investors

An angel investor is typically an affluent, individual investor who provides his or her own funds for a start-up. Capital from angel investors fills the gap between funds available from friends and family (usually much less and not more than a few hundred thousand dollars)¹⁶² and institutional venture firms, which may have minimal thresholds of \$1 to \$3 million. During recent years, as increased institutional funds have flowed into venture capital (VC) firms, the minimum allocation to any one portfolio company has tended to increase because these firms cannot otherwise justify the cost of monitoring and managing an investment that is immaterial to their portfolio’s performance.

An entrepreneur may likely find angel funding advantageous in terms of how control must be relinquished for this form of investor participation. In a study of 182 Series A preferred stock fundings, “derived from the electronic records of the [prestigious but] now defunct law firm Brobeck, Phleger & Harrison (Brobeck),”¹⁶³ Professors Hoberg, Goldfarb, Kirsch and Triantis find that “investor composition is strongly related to control rights, and deals with more angel investors have weaker control rights.”¹⁶⁴ Moreover, the Hoberg et al. study confirms the findings of Aghion and Tirole,¹⁶⁵ Cassamatta,¹⁶⁶ and Hellmann 2002,¹⁶⁷ in that the allocation of control rights go “to the party whose marginal contribution to the project is greatest. [Hoberg, et al.] Hypothesize that angels and VCs primarily differ on their abilities and disposition to influence firm behavior and investment patience. Consistent with this notion, [Hoberg, et al.] find that angel investors generally obtain weaker control rights than do

¹⁶¹ Sarah E. Needleman, *Entrepreneurs Hit Up Family, but Paypack is Slow*, WALL ST. J. Nov 24, 2010, at B6. See Samuel Lee & Petra Persson, *Financing from Family and Friends* (NYU Stern Working Paper FIN-12-007, 2015), <http://ssrn.com/abstract=2086625>; see also BAGLEY & DAUCHY, *supra* note 9, at 145–57 (discussion of friends and family early stage funding and advantages and disadvantages of that and other possible sources of funding discussed below in).

¹⁶² See Gerard Hoberg, Brent D. Goldfarb, David Kirsch & Alexander J. Triantis, *Does Angel Participation Matter? An Analysis of Early Venture Financing* (Robert H. Smith Sch. Res. Paper No. RHS 06-072, March 24, 2009), <http://ssrn.com/abstract=1024186> (The mean investment of \$150,375 made by angels in our sample is large relative to the \$10,000 average outside equity investment made by individuals as reported by Reynolds (2005). Shane (2008) reports that investments over \$200,000 fall in the top one percentile of angel investments).

¹⁶³ Hoberg, *supra* note 162, at 2.

¹⁶⁴ *Id.* at 1.

¹⁶⁵ P. Aghion & P. Bolton, *An Incomplete Contracts Approach to Financial Contracting*, 59(3) REV. ECON. STUD. 473 (1992).

¹⁶⁶ C. Cassamatta, *Financing and Advising: Optimal Financial Contracts With Venture Capitalists*, 58 J. FIN. 2059 (2003).

¹⁶⁷ Hoberg, *supra* note 162, at 2 (citing T. Hellman, *A Theory of Strategic Venture Investing*, 64 J. FIN. ECON. 285 (2002)) (Hellmann and Puri (2000, 2002) document variance in product market strategy and top management team professionalization of VC-backed and non-VC-backed firms. Kaplan and Stromberg (2004) analyze venture capital contracts and find that investor rights vary with the expected and actual investor effort contribution. Dessein (2005) provides an alternative theory of control rights, attributing investor right allocation to signaling. An alternative, and perhaps complementary, explanation is that angels are more patient than VCs (Jovanovic and Szentes 2007). They may relinquish control to mitigate the entrepreneur’s risk of premature liquidation especially when projects require longer time horizons (Lacetera 2008)).

VCs.”¹⁶⁸ The four central findings of the Hoberg, Goldfarb, Kirsch and Triantis study are as follows:

1. When firms raise smaller amounts of capital, they do so from either angels alone, VCs alone, or from both angels and VCs. In contrast, when larger investments are needed, VC participation is generally necessary, suggesting that matching is constrained.
2. In Series A rounds, angels almost always take preferred shares. Nevertheless, the presence of angels, either investing alone or alongside VCs, is associated with weaker cash flow and control rights
3. Among smaller deals, angel-only deals have the lowest incidence of failure, and a similar incidence of IPOs and acquisitions
4. When deals are large, those financed by VCs alone are more successful than those in which angels participate.¹⁶⁹

Traditional Banking and Collateralized Debt Financing

Because many early stage start-up ventures are either too small or lack sufficient unsecured assets to qualify for traditional bank funding, with some exceptions, most commercial banks are not good candidates for unsecured funding. However, several studies illustrate the role of bank financing for entrepreneurial ventures.¹⁷⁰ The uncertain economic environment following the 2008–2009 capital markets’ demise has resulted in commercial banks subsequently being slow to approve loan requests, often due to the deteriorating credit worthiness of potential borrowers. The other side of the same coin is that small borrowers have been reluctant to borrow given economic uncertainty.

Small Business Administration (SBA)

The SBA offers a wide variety of financial assistance programs for small businesses.¹⁷¹ A

¹⁶⁸ Hoberg, *supra* note 162, at 1.

¹⁶⁹ *Id.*

¹⁷⁰ See Andrew Winton & Vijay Yerramilli, *Entrepreneurial Finance: Banks versus Venture Capital*, 88 J. FIN. ECON. 51 (2008); Sheryl Winston Smith, *Beg, Borrow, and Deal? Entrepreneurs’ Choice of Financing and New Firm Innovation* (Mar. 15, 2011), <http://ssrn.com/abstract=1573685>; Linda M. Van De Gucht & Nancy Huyghebaert, *The Determinants of Financial Structure: New Insights from Business Start-Ups* (K.U. Leuven, Dep’t of Applied Econ., Working Paper No. 0203, 2002), <http://ssrn.com/abstract=296841>; Andrew Winton & Vijay Yerramilli, *A Model of Entrepreneurial Finance* (July 2004), <http://ssrn.com/abstract=566921>; Hui Chen, Jianjun Miao & Neng Wang, *Entrepreneurial Finance and Nondiversifiable Risk*, 23 REV. FIN. STUD. 4348 (2010), <http://ssrn.com/abstract=1369293>; William R. Kerr & Ramana Nanda, *Financing Innovation* (Harv. Bus. Sch. Entrepreneurial Mgmt., Working Paper No. 15-034, 2014), <http://ssrn.com/abstract=2519572>; Alicia Robb & David T. Robinson, *The Capital Structure Decisions of New Firms*, 28 REV. FIN. STUD. 1768 (2015), <http://ssrn.com/abstract=1345895>.

¹⁷¹ See *Loans & Grants*, U.S. SMALL BUS. ASS’N, <https://www.sba.gov/category/navigation-structure/loans->

detailed discussion of the various SBA programs offered and their availability is beyond the scope of this article. However, some Small Business Administration programs may prove useful as the government “guarantee” often provides sufficient risk reduction to enable commercial banks to fund the small enterprise.

Small Business Investment Companies (SBICs)

Since 1959, Small Business Investment Companies (SBICs) have supplied equity capital, long-term loans and management assistance to qualifying small businesses.¹⁷² The SBIC Program is one of many financial assistance programs available through the U.S. Small Business Administration. The structure of the program is unique in that SBICs are privately-owned and managed investment funds, licensed and regulated by SBA, that use their own capital plus funds borrowed with an SBA guarantee to make equity and debt investments in qualifying small businesses. Note that the U.S. SBA does not invest directly into small businesses through the SBIC Program. In addition, SBIC financing is not appropriate for all types of businesses and financing needs.

Institutional Venture Capital (VC) Sources

Like most business phenomena, the availability of venture capital sources will wax and wane based on various factors and a correlation to the overall economy that may not prove readily apparent to most. Factors that are prominent in aggregate availability of venture capital will include: a rising equity market that has provided investors with both the investible cash and confidence to make additional venture (highly illiquid) investments, actual and perceived likelihood of near term “new cash” from liquidity events (such as a robust initial public offering (IPO) market), the increase or decrease in portfolio allocation to venture capital as an asset class by major institutional investors (such as the California Public Employees Retirement System (CalPERS), Harvard Endowment, Texas State Teachers System, or the like).¹⁷³ Institutional venture firms serve as intermediaries for these funds, receiving an allocation from such sources as state employee retirement funds or college endowments and tend to be specialized in their focus and staffing expertise to enhance their investment returns.

Do the top venture capital firms provide more than just money to their entrepreneurs? “As

grants (last visited July 3, 2016). *But see* Mirit Eyal-Cohen, 55 B.C. L. REV. 719 (2014) (commenting about how current various governmental classifications fail to assess congressional intent and policy considerations to optimize economic growth).

¹⁷² *Overview: Small Bus. Owners & the SBIC Program*, U.S. SMALL BUS. ASS’N, <https://www.sba.gov/content/sbic-program-seeking-financing-your-small-business> (last visited Aug. 18, 2016).

¹⁷³ Manuel Amador & Augustin Landier, *Entrepreneurial Pressure and Innovation*, AFA 2004 San Diego Meetings (August 15, 2003), <http://ssrn.com/abstract=436320>; Thomas Gehrig & Rune Stenbacka, *Venture Cycles: Theory and Evidence*, 9, 21 (CESifo Working Paper No. 882, 2003), <http://ssrn.com/abstract=386762>; Josh Lerner, *Boom and Bust in the Venture Capital Industry and the Impact on Innovation*, 4–11, 16–17 (Harv. NOM Working Paper No. 03-13, 2002), <http://ssrn.com/abstract=366041>; Ramana Nanda & Matthew Rhodes-Kropf, *Investment Cycles and Startup Innovation*, 2, 6–7 (Harv. Bus. Sch. Entrepreneurial Mgmt., Working Paper No. 12-032, 2012), <http://ssrn.com/abstract=1950581>; *See* Paul A. Gompers, Anna Kovner, Josh Lerner & David S. Scharfstein, *Venture Capital Investment Cycles: The Impact of Public Markets* (Nat’l Bureau of Econ. Res. Working Paper No. 11385, 2005), <http://ssrn.com/abstract=731040>.

has been shown by Sorensen (2004), Kaplan and Schoar (2005), Gompers, Kovner, Lerner and Scharfstein (2006), and Hochberg, Ljungqvist and Lu (2006), companies that are funded by more experienced (top-tier) venture capital firms are better able to identify high quality companies and entrepreneurs.”¹⁷⁴ The Gompers study suggests that by helping start-ups recruit key management, refine strategy, and make important customer contacts—top-tier venture capital firms contribute considerable value in addition to funding. A survey of 549 successful entrepreneurs found that “[v]enture capital and private /angel investments play a relatively small role in the start-ups of first-time entrepreneurs. Only 11 percent received venture capital, and 9 percent received angel financing for their first start-ups.”¹⁷⁵ John F. Coyle and Joseph M. Green report that “[a]round 2005 . . . investors in early-stage technology companies increasingly turned to much simplified versions of traditional convertible preferred stock documents to structure their investments.”¹⁷⁶ Before 2005, individual investors “who invested in early-stage technology companies would typically invest alongside the founder of the new venture by purchasing shares of common stock. Venture capital funds, which invested more substantial amounts of capital at later stages in a company’s development, would typically receive convertible preferred stock.”¹⁷⁷

The New Investment Banking Maze

The failure of Bear Stearns and Lehman Bros. during the 2008-2009 Wall Street meltdown has resulted in a much smaller universe of investment banking firms available to

¹⁷⁴ Ervin L. Black, F. Greg Burton, David A. Wood & Aaron F. Zimbelman, *Entrepreneurial Success: Differing Perceptions of Entrepreneurs and Venture Capitalists*, 11 INT’L J. ENTREPRENEURSHIP & INNOVATION 189 (2010), <http://ssrn.com/abstract=735563>; Douglas J. Cumming & Sofia Johan, *Advice and Monitoring in Venture Finance*, J. BANKING & FIN. 3 (2006), <http://ssrn.com/abstract=642122>; Tom Elfring & Willem Hulsink, *Networks in Entrepreneurship* (ERIM Report Series Reference No. ERS-2001-28-STR, 2016), <http://ssrn.com/abstract=370887>; Grant Fleming, Douglas J. Cumming & Jo-Ann Suchard, *Venture Capitalist Value-Added Activities, Fundraising and Drawdowns*, 29 J. BANKING & FIN. 295 (2005), <http://ssrn.com/abstract=466962>; Paul A. Gompers, Anna Kovner, Josh Lerner & David S. Scharfstein, *Skill vs. Luck in Entrepreneurship and Venture Capital: Evidence from Serial Entrepreneurs*, 2, 18 (July 2006), <http://ssrn.com/abstract=933932> (citing Morten Sorensen, *How Smart is Smart Money? A Two-Sided Matching Model of Venture Capital*, 62 J. FIN. 2 (2007), <http://onlinelibrary.wiley.com/wo11/doi/10.1111/j.1540-6261.2007.01291.x/full>); Yael Hochberg, Alexander Ljungqvist & Yang Lu, *Whom You Know Matters: Venture Capital Networks and Investment Performance*, 62 J. FIN. 251 (2007), http://www.cis.upenn.edu/~mkearns/teaching/NetworkedLife/VC_networks.pdf; Steven N. Kaplan & Antoinette Schoar, *Private Equity Performance: Returns, Persistence and Capital*, 60 J. FIN. 1791 (2005), <http://www.nber.org/papers/w9807.pdf>; Arthur G. Korteweg & Morten Sorensen, *Risk and Return Characteristics of Venture Capital-Backed Entrepreneurial Companies*, 23 REV. FIN. STUD. 3738 (2010), <http://ssrn.com/abstract=1108610>; Suting Hong, *Competition, Syndication, and Entry in the Venture Capital Market* (Fed. Reserve Bank of Phila., Working Paper No. 13-49, 2013), <https://www.philadelphiafed.org/research-and-data/publications/working-papers/2013/>. Mark J. Garmaise, *Informed Investors and the Financing of Entrepreneurial Projects*, EFMA 2001 LUGANO MEETINGS (2001), <http://ssrn.com/abstract=263162>.

¹⁷⁵ Wadhwa, *supra* note 5, at 4–6.

¹⁷⁶ See John F. Coyle & Joseph M. Green, *Contractual Innovation in Venture Capital*, 66 HASTINGS L.J. 133, 134 (2014), <http://ssrn.com/abstract=2417431>; See generally Jason M. Gordon & David Orozco, *Trust and Control: The Value Effect of Venture Capital Term Sheet Provisions as Risk Allocation Tools*, 4 MICH. BUS. & ENTREPRENEURIAL L. REV. 195 (2015), <http://repository.law.umich.edu/mbelr/vol4/iss2/2> (discussing how term sheet provisions delineate the subjective risk perceptions of each party to the transaction by allocating control or trusting a party with decision-making rights).

¹⁷⁷ See Coyle & Green, *supra* note 176, at 133.

handle the funding needs of smaller enterprises. Major bracket firms such as Goldman Sachs or Credit Suisse may have venture capital units, but are simply not structured to deal with microcap clients. Because less “public Wall Street” research tends to be available for very small publicly-traded companies, the universe of potential investment banking assistance will be limited to a relatively few firms.

Franchising Strategy

Franchising is recognized as an important form of organization.¹⁷⁸ A franchising strategy can be both a source of financing and a strategy for increased business growth. Most states heavily regulate business franchises and require registration of extensive offering memoranda for the sale of franchise units. Once again, this is a legal practice specialty.

Crowdfunding

The impact of small business growth on job creation and economic expansion continues to grow, but there is a downward trend in the willingness of venture capital firms to invest in seed-stage companies. Non-equity crowdfunding fills in this gap by providing much-needed seed funding and spreading the risks broadly across the crowd so that the cost of failure to any one contributor is minimal. Non-equity crowdfunding has proven to be a great way to test out new ideas, finance micro-startups and weed out bad business ideas at an early stage.¹⁷⁹

¹⁷⁸ See Robert W. Emerson, *Franchising and the Parol Evidence Rule*, 50 AM. BUS. L.J. 659 (2013); see Norman Bishara & Cindy A. Schipani, *A Corporate Governance Perspective on the Franchisor-Franchisee Relationship* (Ross Sch. of Bus. Working Paper No. 1245, 2014), <http://ssrn.com/abstract=2467524>; see generally Jonathan Klick, Bruce H. Kobayashi & Larry E. Ribstein (Deceased), *The Effect of Contract Regulation: The Case of Franchising 2* (George Mason L. & Econ. Working Paper No. 07-03, 2006), <http://ssrn.com/abstract=951464>.

¹⁷⁹ Ajay Agrawal, Christian Catalini & Avi Goldfarb, *The Geography of Crowdfunding*, U. TORONTO L.J. (2011), <http://ssrn.com/abstract=1692661>; Paul Belleflamme, Thomas Lambert & Armin Schwienbacher, *Crowdfunding: Tapping the Right Crowd*, 29 J. BUS. VENTURING 585 (2013), <http://ssrn.com/abstract=1578175>; see also Ethan R. Mollick, *The Dynamics of Crowdfunding: An Exploratory Study*, 29 J. BUS. VENTURING 1 (2013), <http://ssrn.com/abstract=2088298>; see generally David Orozco, *The Use of Legal Crowdsourcing ('Lawsourcing') as a Means to Achieve Legal, Regulatory and Policy Objectives*, 53 AM. BUS. L.J. 1 (2016), <http://ssrn.com/abstract=2520515> (discussing lawsourcing and legal Q&A platforms, government participation forums, and strategic nonmarket practices); see, e.g., Nikki D. Pope, *Crowdfunding Microstartups: It's Time for the Securities and Exchange Commission to Approve a Small Offering Exemption*, 13 U. PA. J. BUS. L. 973, 103, 113, 122–29 (2013), <http://scholarship.law.upenn.edu/jbl/vol13/iss4/5>; Gerrit K.C. Ahlers, Douglas J. Cumming, Christina Guenther & Denis Schweizer, *Signaling in Equity Crowdfunding*, *Entrepreneurship Theory and Practice* (forthcoming 2016), <http://ssrn.com/abstract=2564121>; Karima Bouaiss & Isabelle Maque, *Cartography of Academic Literature on Crowdfunding* (Mar. 4, 2015), <http://ssrn.com/abstract=2573739>; Praveen Kumar, Nisan Langberg & David Zvilichovsky, *(Crowd)funding Innovation* (2015), <http://ssrn.com/abstract=2600923>; Jordana Viotto, *Crowdfunding: A Progress Report* (2015), <http://ssrn.com/abstract=2592443>; Alex Murray, Suresh Kotha & Greg Fisher, *Persuading Crowds: Mindset, Learning and Influence Mechanisms in Crowdfunding* (Kelley Sch. of Bus. Res. Paper No. 15-27 Campaigns, 2015), <http://ssrn.com/abstract=2584583>; see generally Venkat Kuppaswamy & Barry L. Bayus, *A Review of Crowdfunding Research and Findings*, in HANDBOOK OF NEW PRODUCT DEVELOPMENT RESEARCH (forthcoming 2016), <http://ssrn.com/abstract=2685739> (discussing key findings from empirical crowdfunding literature); see generally Othmar Lehner, Elisabeth Grabmann & Carina Ennsgraber, *Entrepreneurial Implications of Crowdfunding as Alternative Funding Source for Innovations*, ROUTLEDGE VENTURE CAPITAL 18(1) (forthcoming 2016), <http://ssrn.com/abstract=2681974> (discussing dealing with large groups of investors brings serious corporate governance repercussions and unforeseeable global business problems).

The music and film industry provided the genesis for crowdfunding by soliciting donations from supporters to fund music recordings or cinema projects.¹⁸⁰ Artists often accept donations over the Internet or pre-sell CDs of music or films with a promise of sending the final product when it becomes available. Early movers in the crowdfunding space include Kickstarter¹⁸¹ and Indiegogo.¹⁸² Kickstarter, which focuses on creative projects, claims that since 2009 a total of more than \$2.11 billion has been pledged to Kickstarter projects; 97,067 projects have been successfully funded by 9.97 million backers.¹⁸³

Contributions received through crowdfunding can be separated into the “gift” category or the “investment” category.¹⁸⁴ Contributions that are considered gifts (donations, reward, or pre-purchases) are given to the fundraising entrepreneurs without any expectation of equity or other participation in future earnings.¹⁸⁵ Contributions considered to be investments are those that have repayment terms and may involve a return.¹⁸⁶ If the contribution can be classified as a security (whether an equity security or debt security) the “offering” involved in such crowdfunding must be registered or an exemption must be found under the rules described in Section 5 Raising Capital. Under the donation model, contributors donate their money and receive nothing in return for their contribution.¹⁸⁷ Even though contributors under the reward and the pre-purchase model receive neither interest nor a portion of business earnings, contributors may receive a diverse range of rewards, from small tokens like key chains, to opportunities to pre-purchase items produced by the funded projects.

Contributions classified as gifts are presumably not subject to the securities laws. Even though the donation model involves the investment of money in a common enterprise, it does not satisfy the third element of the *Howey* test because profits are not expected. Contributors know in advance that they will not receive a return of any kind and gratuitous contributions are not securities. Contributors in both the reward and pre-purchase models do expect a return, but to classify as an investment contract under the *Howey* test, the reward must be of a financial nature, “such as capital appreciation or a participation in earnings or even a fixed rate of interest.”¹⁸⁸ Accordingly, because the *Howey* Test is not met for those contributions classified as gifts, capital raised through crowdfunding under the reward, pre-purchase or donation models do not fall under the definition of a security and thus, the federal securities laws Act do

¹⁸⁰ See generally Michael A. Carrier, *No, RIAA, It's Not the End of the World for Musicians*, 82 UMKC L. REV. 287, 297–98 (2015), <http://ssrn.com/abstract=2602469>; see generally Patryk Galuszka & Victor Bystrov, *Crowdfunding: A Case Study of a New Model of Financing Music Production*, 13 J. INTERNET COMM. 233 (2014), <http://ssrn.com/abstract=2523843>.

¹⁸¹ *About Us*, KICKSTARTER, <https://www.kickstarter.com/about?ref=nav> (last visited July 3, 2016); see Venkat Kuppaswamy & Barry L. Bayus, *Crowdfunding Creative Ideas: The Dynamics of Project Backers in Kickstarter* (UNC Kenan-Flagler Res. Paper No. 2013-15, 2014), <http://ssrn.com/abstract=2234765>.

¹⁸² *About Us*, INDIEGOGO, <http://www.indiegogo.com/about/our-story> (last visited July 3, 2016).

¹⁸³ See *Stats*, KICKSTARTER, <https://www.kickstarter.com/help/stats?ref=footer> (last visited July 3, 2016) and Appendix A to this article regarding completed Kickstarter Funded Projects.

¹⁸⁴ C. Steven Bradford, *Crowdfunding and the Federal Securities Laws*, U.S. SEC. & EXCH. COMM'N 10, 13, 21, 27 (Oct. 10, 2011), http://www.sec.gov/info/smallbus/acsec/bradford_crowdfunding.pdf.

¹⁸⁵ *Id.* at 14.

¹⁸⁶ *Id.* at 15.

¹⁸⁷ *Id.* at 21.

¹⁸⁸ Bradford, *supra* note 184, at 21.

2016] SOME KEY THINGS U.S. ENTREPRENEURS NEED TO KNOW 191

not apply.

The other basic model, the equity model, clearly involves investments with a return and profit motive.¹⁸⁹ The equity model allows contributors a speculative right to return of capital and to have an interest in the “profits or a return of the business they are helping to fund.”¹⁹⁰ Again, whether or not contributions made under these two models can be considered securities is relevant to determine if registration is required or an exemption must be sought.

For the reasons described above,¹⁹¹ for-profit stock is essentially always a security, and equity interests in unincorporated business entities are tested for “investment-contract” (and thus “securities” status) under the *Howey* test. The application of the *Howey* test to investments made under the equity model is fairly straightforward. In the equity model of crowdfunding, all elements of the *Howey* test are extremely likely to be satisfied. There is clearly an investment of money, in a common enterprise, with an expectation of profits arising solely from the managerial efforts of others.

The JOBS Act of 2012, establishes a regulatory foundation to enable small businesses to access new capital using crowdfunding.¹⁹² Title III of the JOBS Act creates an exemption under the U.S. securities laws, allowing investors to raise \$1 million in capital through the offer and sale of securities to the public through crowdfunding platforms.¹⁹³ These crowdfunding provisions “include investment restrictions and new compliance requirements for both small businesses seeking to obtain funds through crowdfunding and the portals that will connect entrepreneurs and investors.”¹⁹⁴ Congress intended to lower regulatory barriers in order to give small companies and start-ups a larger pool of investors from which to raise capital, but whether that objective has been accomplished remains to be seen. Congress tasked the SEC with adopting rules and regulations to implement the new law, but the SEC stalled for three long years before adopting in October 2015 final regulations to implement the crowdfunding exemption.¹⁹⁵¹⁹⁶ In the interim, some states enacted crowdfunding exemptions for certain types of intrastate crowdfunded securities offerings.¹⁹⁷

¹⁸⁹ *Id.* at 16.

¹⁹⁰ *Id.*

¹⁹¹ See *supra* notes 99–111 and accompanying text.

¹⁹² Jumpstart Our Business Startups Act, Pub. L. No. 112-106, 126 Stat. 306 (2012) (codified at scattered sections of 15 U.S.C. ch. 2A and 2B). See also David C. Brown & Shaun William Davies, *Equity Crowdfunding: Harnessing the Wisdom of the Crowd* (Nov. 18, 2015), <http://ssrn.com/abstract=2692828> (finding individual investment limits benefit all investors by improving financing efficiency).

¹⁹³ Press Release 2013-227, *SEC Issues Proposal on Crowdfunding*, Sec. & Exch. Comm’n (Oct. 23, 2013), <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540017677>.

¹⁹⁴ SEC Release Nos. 33-9974: 34-76324, 80 Fed. Reg. 220, 71387 (Nov. 16, 2015) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, 249, 269, and 274). See also *SEC’s Crowdfunding Proposal: Will it work for Small Businesses?* Hearing Memo on Pub. L. No. 112-106 Before the H. Comm. On Small Business Subcommittee on Investigations, Oversight and Regulations, 113th Cong. (Jan. 13, 2014), http://smallbusiness.house.gov/uploadedfiles/1-16-2014_revised_hearing_memo.pdf.

¹⁹⁵ SEC Release Nos. 33-9974: 34-76234, Sec. & Exch. Comm’n, 80 Fed. Reg. 220, 71387.

¹⁹⁶ The SEC issued proposed rules in October 2013. See SEC Release Nos. 33-9470: 34-76234, Sec. & Exch. Comm’n, 78 Fed. Reg. 214, 66428 (Nov. 5, 2013) (to be codified at 17 C.F.R. pts. 200, 227, 232, 239, 240, and 249).

¹⁹⁷ Kansas and Georgia were among the first states to adopt an intrastate crowdfunding exemption. Other states

Under the new regulations, issuers may raise a maximum aggregate amount of \$1 million in a 12-month period.¹⁹⁸ These crowdfunded securities are restricted and cannot be resold for one year.¹⁹⁹ The amount that individuals may invest is tiered and is determined by the investor's net worth or annual income. For investors with an annual income or net worth less than \$100,000, they may invest the greater of \$2,000 or 5% of the lesser amount of their annual income or net worth.²⁰⁰ If an investor has a combined annual income and net worth equal to or more than \$100,000, then they may invest 10% of the lesser amount of their annual income or net worth.²⁰¹ The SEC limits the amount of securities sold to an investor through the crowdfunding exemption to \$100,000.²⁰²

The regulations also include a list of companies that are ineligible for the exemption. Among the ineligible companies are those that have failed to comply with the annual crowdfunding exemption reporting requirements during the two years prior to the filing of the offering statement, or companies that have no specific business plan.²⁰³ The company issuing these crowdfunded securities is also required to disclose certain information including a description of the business, use of proceeds, financial statements,²⁰⁴ information about the officers, directors, and anyone holding more than 20% equity.²⁰⁵

In addition to requirements for the companies issuing securities and the requirements for those who invest, crowdfunding platforms (which connect the investors with the companies) are required to register with the SEC and follow its guidelines.²⁰⁶ All exempted crowdfunding transactions must occur through an intermediary registered with the SEC.²⁰⁷ The SEC requires these intermediaries to provide investors with educational materials, implement measures to reduce fraud, and facilitate communications about offerings on the platform. These intermediaries are prohibited from certain activities including: offering investment advice and making recommendations; "soliciting purchases, sales or offers to buy securities offered or displayed on its platform;" compensating promoters and others for solicitations or sales of its securities.²⁰⁸

including, Alabama, Michigan, and Virginia have followed. See Herrick K. Lidstone, *Crowdfunding in Colorado – State Rules versus the Federal Rules* (Nov. 11, 2015), <http://ssrn.com/abstract=2689415>; see *Intrastate Crowdfunding Resource Center*, N. AM. SEC. ADMIN. ASS'N, <http://www.nasaa.org/industry-resources/corporation-finance/intrastate-crowdfunding-resource-center/> (last visited July 3, 2016); *Intrastate Crowdfunding Legislation & Regulation Directory*, N. AM. SEC. ADMIN. ASS'N, <http://www.nasaa.org/industry-resources/corporation-finance/intrastate-crowdfunding-resource-center/intrastate-crowdfunding-directory/> (last visited July 3, 2016).

¹⁹⁸ See *supra* note 195.

¹⁹⁹ *Id.*

²⁰⁰ *Id.*

²⁰¹ *Id.*

²⁰² *Id.*

²⁰³ *Id.*

²⁰⁴ *Id.* The size of the issuer will determine whether the financial statements should be reviewed by an independent public accountant or audited by an independent auditor.

²⁰⁵ *Id.* The SEC defines beneficial ownership based on the total outstanding voting securities.

²⁰⁶ *Id.*

²⁰⁷ *Id.*

²⁰⁸ *Id.*

The Securities and Exchange Commission voted three to one to approve the new crowdfunding regulations. One Commissioner who voted against the regulations fears the regulations are too burdensome to really aid small businesses in raising capital.²⁰⁹ He stated, “I fear that many traps for the unwary are hidden in the regulations, creating potential nightmares for small business owners that fail to place regulatory compliance at the top of their business plans. Such burdens will spook many small businesses from pursuing crowdfunding as a viable path to raising capital,”²¹⁰ the staff has committed to studying crowdfunding and how the regulations impact capital formation while providing investor protection. The SEC will issue a report within three years.²¹¹

CREDITOR’S RIGHTS

If there is one thing you can count on in a start-up, it’s that things will go wrong. Studies show that about 25 percent of all entrepreneurial start-ups will fail within the first year and that by year five, less than half survive.²¹² As discussed more fully above in Section IV (“Principal Choice of Entity Considerations”), a primary goal in selecting the type of entity in which to conduct business concerns the ability to limit the personal liability of individuals involved in the entity. Often, it is when things go wrong that the wisdom of having previously obtained good legal advice is appreciated. Unfortunately, several scenarios may place an entrepreneur in the unfortunate position of needing legal advice regarding debt collection, secured credit, and bankruptcy.

Debt Collection

As an entrepreneur, understanding your rights as a *creditor* will require experienced legal advice.²¹³ Each business, whether serving consumers or other businesses, will want to make sure that payment is received from its customers, hopefully without prodding. To ensure its written contracts are optimal for achieving payment, an experienced commercial law attorney can advise a company about what the contract should say before execution. In doing so the company will maximize its chances of prevailing if judicial action must be taken for collection. Conversely, a company will want to have its attorney review any written contracts its vendors and supplies present for approval. This is especially recommended for the very one-sided contracts proffered by “predatory” vendors such as those offering credit card services/machines or cash incentives for long-term purchasing agreements (such as gasoline suppliers to convenience stores, for instance, which typically offer cash payments to entice business owners into signing).

²⁰⁹ See Michael Erman, *U.S. Approves New Crowdfunding Rules*, REUTERS (Oct. 30, 2015), <http://venturebeat.com/2015/10/30/u-s-sec-approves-new-crowdfunding-rules/>.

²¹⁰ *Id.*

²¹¹ See *supra* note 195.

²¹² Jeffrey Pfeffer, *Evidence-Based Management for Entrepreneurial Environments: Faster and Better Decisions with Less Risk*, 2 (Stan. Univ. Grad. Sch. of Bus. Res. Paper No. 2051, 2010), <http://ssrn.com/abstract=1564422>; see also E. J. Reedy & Robert E. Litan, *Starting Smaller; Staying Smaller: America’s Slow Leak in Job Creation* (July 2011), http://www.kauffman.org/~media/kauffman_org/research%20reports%20and%20covers/2011/07/job_leaks_starting_smaller_study.pdf.

²¹³ See BAGLEY & DAUCHY, *supra* note 9, at ch. 12 (“Creditors’ Rights and Bankruptcy”).

Secured Credit

The entrepreneur who seeks a commercial lender will also want to have an attorney explain loan documents and their consequences, especially if the loan terms will require a personal guarantee of the business owner (even if the loan is made in the name of the entity). Often the lender will require some security,²¹⁴ which can include: the land and buildings being purchased, inventories, receivables, or even the home of the business owner or other personal assets. The borrower will want to fully understand the consequences, and explore alternatives if any are available.

Bankruptcy

Bankruptcy is another topic requiring specialized legal advice and much has been written on the subject.²¹⁵ In one scenario, many entrepreneurs find themselves in the position of having to “sign personally” as parties responsible for the repayment of debt obligations if the enterprise should be unable to promptly repay. On the other hand, the entrepreneur may need legal advice regarding the collection of receivables or may need to collect on a note secured by collateral. Depending on the size of legal community in which the entrepreneur finds herself, or the jurisdiction in which the adverse party resides or has its principal place of business—finding experienced legal representation may or may not prove difficult.

As a creditor to someone else’s bankruptcy, an entrepreneur will want legal representation in filing a claim, foreclosing on secured property, and otherwise making sure its claim is recognized with proper lien priority in the distribution of any proceeds from the liquidation of the bankrupt’s non-exempt assets. The entrepreneur might also want to investigate the possibility that insurance coverage for debtor default in some industries may be available. As a debtor, the entrepreneur may find early assistance from an attorney could mean negotiated forbearance from certain creditors which might avoid bankruptcy. If unavoidable, the business owner may need to choose between a company bankruptcy or a personal bankruptcy if he or

²¹⁴ See generally Alvin C. Harrell, *2011–2013 Secured Transactions Review*, 68 CONSUMER FIN. L.Q. REP. 157 (2014); Alvin C. Harrell, *The 2010 Amendments to the Uniform Text of Article 9*, 65 CONSUMER FIN. L.Q. REP. 138 (2011).

²¹⁵ Kenneth Ayotte, *Bankruptcy and Entrepreneurship: The Value of a Fresh Start*, 23 J. L. ECON. & ORG. 161 (2007), <http://ssrn.com/abstract=463000>; Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751 (2002) (observing that the vast majority of firms in financial distress never enter bankruptcy); Jean Braucher, *The Challenge to the Bench and Bar Presented by the 2005 Bankruptcy Act: Resistance Need Not be Futile*, 2007 U. ILL. L. REV. 93 (2007), <http://ssrn.com/abstract=947930>; Sergei A. Davydenko & Julian R. Franks, *Do Bankruptcy Codes Matter? A Study of Defaults in France, Germany and the UK*, 63 J. FIN. 565 (2008), <http://ssrn.com/abstract=647861>; Alvin C. Harrell & Jon Ann Giblin, *A Review of the 2005 Bankruptcy Code Amendments: Impact on Creditors’ Operations*, 62 CONSUMER FIN. L.Q. REP. (2008); Stephen A. Hillegeist, Elizabeth K. Keating, Donald P. Cram & Kyle G. Lundstedt, *Assessing the Probability of Bankruptcy*, 9 REV. ACCT. STUD. 5 (2004); Edith S. Hotchkiss, John Kose, Karin S. Thorburn & Robert M. Mooradian, *Bankruptcy and the Resolution of Financial Distress* (Jan. 2008), <http://ssrn.com/abstract=1086942>; Seung-Hyun Lee, Yasuhiro Yamakawa, Mike W. Peng & Jay B. Barney, *How Do Bankruptcy Laws Affect Entrepreneurship Development Around the World?*, 26 J. BUS. VENTURING 505 (2011); Mike W. Peng, Yasuhiro Yamakawa, Seung-Hyun Lee & Jay B. Barney, *Bankruptcy Laws and Entrepreneur-Friendliness*, ENTREPRENEURSHIP THEORY & PRAC. 517 (May 2010); see generally Stephen J. Ware, *An Overview of Bankruptcy Law in the United States*, 9 INT’L CORP. RESCUE 320 (2012) (providing an overview of bankruptcy and debtor-creditor law in the United States).

she has given a personal guarantee. An experienced bankruptcy attorney will help advise the entrepreneur in any of those events.

LEGAL ISSUES WITH EMPLOYEES

Entrepreneurs also need to understand that a venture having one or more employees faces a wide array of legal issues and associated compliance obligations flowing from the employer-employee relationship. As a threshold matter, a determination must be made as to whether workers are employees or independent contractors. Misclassifying a worker as an independent contractor when in fact the worker is an employee can create a host of problems for the employer—such as liability for failure to withhold and remit payroll taxes. Unfortunately, proper classification can be difficult because it involves a multi-factored analysis of the facts and circumstances essentially designed to determine if the employer controls the worker in a manner sufficient to result in employee status.²¹⁶ Thus, entrepreneurs should seek legal counsel to help with this analysis, and in unclear situations may want to ask for a governmental determination.²¹⁷

If one or more employees will be hired, various federal and state laws specific to the employer-employee relationship can come into play, including, among others: payroll tax obligations, laws prohibiting discriminatory practices, sexual harassment,²¹⁸ fair labor standards and collective bargaining laws, laws relating to pensions and health plans, workplace safety laws, Affordable Care Act requirements, unemployment insurance laws, employer social media policies,²¹⁹ issues surrounding immigration and work permit policies for foreign

²¹⁶ See, e.g., BAGLEY & DAUCHY, *supra* note 9, at 198–203; HAMILTON, ET AL. *supra* note 81, at 19–23; see *Independent Contractor (Self Employed) or Employee?*, I.R.S., <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Independent-Contractor-Self-Employed-or-Employee> (last visited July 3, 2016).

²¹⁷ See *Form SS-8 Processing*, I.R.S. MANUAL 7.50.1, http://www.irs.gov/irm/part7/irm_07-050-001r.html (last visited July 3, 2016). But see Taxpayer Advocate Service, *IRS Worker Classification Program: Current Procedures Cause Delays and Hardship for Businesses and Workers by Failing to Provide Determinations Timely and Not Affording Independent Review of Adverse Decisions*, Most Serious Problems #19, 2013 Annual Rpt. To Cong., <http://www.taxpayeradvocate.irs.gov/2013-annual-report/downloads/IRS-WORKER-CLASSIFICATION-PROGRAM-Current-Procedures-Cause-Delays-and-Hardships-for-Businesses-and-Workers.pdf> (last visited Dec. 3, 2015).

²¹⁸ See generally BAGLEY & DAUCHY, *supra* note 9, at ch. 8 (“Marshaling Human Resources”); DRAKE, *supra* note 9, at ch. 15 (“The Enterprise Employees”); Lynn McLain, *Recurring Nightmares? Evidence Issues that Keep Coming Back in Employment Cases* (July 23, 2010), <http://ssrn.com/abstract=1652353>; Gundars Kaupins & Susan Park, *Legal and Ethical Issues Associated with Employee Use of Social Networks*, 1 ADVANCES BUS. RES. 82 (2010), <http://ssrn.com/abstract=2309702>; Megan Whitehill, Note, *Better Safe Than Subjective: The Problematic Intersection of Prehire Social Networking Checks and Title VII Employment Discrimination*, 85 TEMP. L. REV. 229 (2012), <http://ssrn.com/abstract=2158831> (discussing use of social networks in hiring decisions).

²¹⁹ See generally Robert Sprague, *Invasion of the Social Networks: Blurring the Line between Personal Life and the Employment Relationship*, 50 U. LOUISVILLE L. REV. 1 (2011), <http://ssrn.com/abstract=1773049>; Robert Sprague, *Facebook Meets the NLRB: Employee Online Communications and Unfair Labor Practices*, 14 U. PA J. BUS. L. 957 (2012), <http://ssrn.com/abstract=1982717>; Robert Sprague & Abigail E. Fournier, *Online Social Media and the End of the Employment-at-Will Doctrine*, 52 WASHBURN L.J. 557 (2013), <http://ssrn.com/abstract=2224093>; Christine Neylon O’Brien, *The National Labor Relations Board: Perspectives on Social Media*, 8 CHARLESTON L. REV. 411 (2014), <http://ssrn.com/abstract=2442385>; Christine Neylon O’Brien, *The First Facebook Firing Case Under Section 7 of the National Labor Relations Act: Exploring the Limits of Labor Law Protection for Concerted Communication on Social Media*, 45 SUFFOLK U. L. REV. 29 (2011), <http://ssrn.com/abstract=1967637>; Christine Neylon O’Brien, *The*

nationals,²²⁰ and workers' compensation obligations.²²¹ Compliance with many aspects of such employment laws can be a relatively straightforward matter, while other issues involved may be quite complex. Constant technological changes result in new legal issues between employers and employees. As just one example, Professor Jasmine Abdel-khalik points to recent controversies "about who owns LinkedIn accounts of executives when they leave the business . . . as valuable contacts can travel with someone when [he or she] leaves. Perhaps companies should consider starting to institute policies about ownership of LinkedIn accounts."²²² A business is well-served to engage legal counsel well-versed in employment laws compliance planning as part of the overall planning of a business venture.²²³

Top Ten NLRB Cases on Facebook Firings and Employer Social Media Policies, 92 OR. L. REV. 337 (2013), <http://ssrn.com/abstract=2277900>; Willow Jacobson & Shannon Tufts, *To Post or Not to Post: Employee Rights and Social Media*, APSA 2011 Annual Meeting Paper, <http://ssrn.com/abstract=1900942>.

²²⁰ See generally Vivek Wadhwa, AnnaLee Saxenian, Richard B. Freeman & G. Gereffi, *America's Loss is the World's Gain: America's New Immigrant Entrepreneurs, Part 4* (Mar. 2, 2009), <http://ssrn.com/abstract=1348616>; Vivek Wadhwa, Guillermina Jasso, Ben A. Rissing, G. Gereffi & Richard B. Freeman, *Intellectual Property, the Immigration Backlog, and a Reverse Brain-Drain: America's New Immigrant Entrepreneurs, Part III* (Aug. 22, 2007), <http://ssrn.com/abstract=1008366>; Vivek Wadhwa, Ben A. Rissing, AnnaLee Saxenian & G. Gereffi, *Education, Entrepreneurship and Immigration: America's New Immigrant Entrepreneurs, Part II* (June 11, 2007), <http://ssrn.com/abstract=991327>; Vivek Wadhwa, AnnaLee Saxenian, Ben A. Rissing & G. Gereffi, *America's New Immigrant Entrepreneurs: Part I* (Duke Science, Techn. & Innovation Paper No. 23, 2007), <http://ssrn.com/abstract=990152>; Dane Stangler & Jared Konczal, *Give Me Your Entrepreneurs, Your Innovators: Estimating Employment Impact of a Startup Visa*, Ewing Marion Kauffman Foundation (2013), <http://ssrn.com/abstract=2226454>.

²²¹ See generally Gregory M. Duhl & Jaclyn S. Millner, *Social Networking and Workers' Compensation Law at the Crossroads*, 31 PACE L. REV. 1 (2011), <http://ssrn.com/abstract=1675026>.

²²² Abdel-khalik, *supra* note 76. See, e.g., *Eagle v. Morgan*, 2013 U.S. Dist. LEXIS 34220 (E.D. Pa. Mar. 12, 2013) (finding liability on some counts but ordering zero compensatory or punitive damages in a dispute over a former employee's LinkedIn account); *Jefferson Audio Visual Sys. v. Gunnar Light*, 2013 U.S. Dist. LEXIS 66239 (W.D. Ky. May 8, 2013) (dismissing a misrepresentation claim based on a former employee's failure to update his LinkedIn account to reflect that he was terminated from his job with the employer). See generally Hugh McLaughlin, *You're Fired: Pack Everything but Your Social Media Passwords*, 13 NW. J. TECH. & INTELL. PROP. 87 (2015); Courtney J. Mitchell, *Keep Your Friends Close: A Framework for Addressing Rights to Social Media Contacts*, 67 VAND. L. REV. 1459 (2014); Zoe Argento, *Whose Social Network Account? A Trade Secret Approach to Allocating Rights*, 19 MICH. TELECOMM. TECH. L. REV. 201 (2013); Steve Anderson, *Who Owns a Social Profile? You or Your Company?*, LINKEDIN (Aug. 7, 2013), <https://www.linkedin.com/pulse/20130807115218-5214630-who-owns-a-social-profile-you-or-your-company>.

²²³ For general information regarding several of the federal laws pertaining to the employer-employee relationship see: Employers Tax Guide at <http://www.irs.gov/pub/irs-pdf/p15.pdf> (federal payroll tax obligations); U.S. Equal Employment Opportunity Commission "About EEOC" discussion at <http://www.eeoc.gov/eeoc/> (employment discrimination claims); EEOC discussion of sexual harassment laws at http://www.eeoc.gov/laws/types/sexual_harassment.cfm; U.S. Department of Labor-Wage and Hour Division webpage regarding compliance with the Fair Labor Standards Act at <http://www.dol.gov/whd/flsa/>; National Labor Relations Board webpage on Employer/Union Rights and Obligations at <http://www.nlr.gov/rights-we-protect/employerunion-rights-and-obligations>; U.S. Department of Labor-Health Plans and Benefits/Employee Retirement Income Security Act-ERISA at <http://www.dol.gov/dol/topic/health-plans/erisa.htm>; U.S. Department of Labor-Occupational Safety & Health Administration Help for Employers webpage at <https://www.osha.gov/employers/index.html> and Small Business webpage at <https://www.osha.gov/dosp/smallbusiness/index.html>; I.R.S. Questions and Answers on Employer Shared Responsibility Provisions Under the Affordable Care Act at <http://www.irs.gov/Affordable-Care-Act/Employers/Questions-and-Answers-on-Employer-Shared-Responsibility-Provisions-Under-the-Affordable-Care-Act>; U.S. Small Business Administration webpage on Affordable Care Act obligations of Employers with 50 or More

In addition to the need to engage legal counsel to assist with compliance issues, an entrepreneur should consider hiring a lawyer to advise on the negotiation of employment contracts with key employees. This can be especially true if the contract is to include “restrictive covenants”—such as confidentiality agreements, non-compete agreements and a promise to not solicit the venture’s customers or other employees—that can have enforceability issues (which vary from state-to-state).²²⁴ Professors John F. Coyle and Gregg D. Polsky report that leading Silicon Valley technology companies such as Google and Facebook, “have been buying start-up companies at a brisk pace. In many of these transactions, the buyer has little interest in acquiring the startup’s projects or assets. Instead, the buyer’s primary motivation is to hire some or all of the startup’s software engineers.”²²⁵ This increasingly common strategy allows technology companies to “satisfy their intense demand for engineering talent”²²⁶ with these “acqui-hires.”

RISK AWARENESS AND MANAGEMENT

With the 2007–2008 global financial crisis, Massey Energy coal mining tragedy, BP Gulf of Mexico oil spill disasters during 2010, and growing epidemic of cybersecurity breaches, business enterprises everywhere have cast renewed focus on the topic of risk management.²²⁷

Employees at <https://www.sba.gov/content/employers-50-or-more-employees>; and U.S. Department of Labor Unemployment Insurance webpage (discuss federal-state collaborations) at <http://www.dol.gov/dol/topic/unemployment-insurance/> (all last visited July 3, 2016). State laws on payroll taxes, workers compensation and various other employer obligations can vary from state-to-state, and entrepreneurs will need to consider the laws of all states in which they operate. One useful tool for startup companies and their legal advisors to include in their research into state law obligations to employees and other compliance obligations for operating a business in particular states is the I.R.S. Starting a Business webpage at <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Starting-a-Business>, that includes state-by-state links to starting a business on-line resources at <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/State-Links-1> (last visited July 3, 2016); Jeffrey Scott Ray, *Evolving Human Resource (HR) Management to Cope with Disruptive Innovation Technologies* (Nov. 11, 2012), <http://ssrn.com/abstract=2173815>.

²²⁴ See generally Kyle B. Sill, *Drafting Effective Noncompete Clauses and Other Restrictive Covenants: Considerations Across the United States*, 14 FLA. COASTAL L. REV. 365 (2013); Margo E. K. Reder & Christine Neylon O’Brien, *Managing the Risk of Trade Secret Loss Due to Job Mobility in an Innovation Economy with the Theory of Inevitable Disclosure*, 12 J. HIGH TECH. L. 373 (2012), <http://ssrn.com/abstract=2014051>; Peter Swire, *A Theory of Disclosure for Security and Competitive Reasons: Open Source, Proprietary Software, and Government Agencies*, 42 HOUS. L. REV. 1333 (2006), <http://ssrn.com/abstract=842228>; Ronald J. Gilson, *The Legal Infrastructure of High Technology Industrial Districts: Silicon Valley, Route 128, and Covenants Not to Compete*, 74 N.Y.U. L. REV. 575 (1999), <http://ssrn.com/abstract=124508>; Jay P. Kesan & Carol M. Hayes, *The Law and Policy of Non-Compete Clauses in the United States and Their Implications*, in *COMPARATIVE BUSINESS INNOVATION: A LEGAL BALANCING ACT*, (Marilyn Pittard, ed., Edward Elgar Pub., 2013), <http://ssrn.com/abstract=1948593>; Randall S. Thomas, Norman Bishara & Kenneth J. Martin, *An Empirical Analysis of Non-Competition Clauses and Other Restrictive Post-Employment Covenants*, 68 VAND. L. REV. 1 (2015), <http://ssrn.com/abstract=2401781>; Marion G. Crain, *Arm’s Length Intimacy: Employment as Relationship*, WASH. U. J.L. & POL’Y 163 (2011), <http://ssrn.com/abstract=1940691>; Catherine Fisk & Adam Patrick Barry, *Contingent Loyalty and Restricted Exit: Commentary on the Restatement of Employment Law*, 16 EMP. RTS. & EMP. POL’Y J. 1 (2012), <http://ssrn.com/abstract=2060621>; Andrea M. Matwyshyn, *Imagining the Intangible*, 34 DEL. J. CORP. L. 965 (2009), <http://ssrn.com/abstract=1473590>.

²²⁵ John F. Coyle & Gregg D. Polsky, *Acqui-hiring*, 63 DUKE L.J. 281 (2013).

²²⁶ *Id.* at 281.

²²⁷ See generally David F. Larcker, Sarah M. Larcker & Brian Tayan, *Lululemon: A Sheer Debacle in Risk Management* (Stan. Closer Look Series No. CGRP-41, Stan. Univ. Grad. Sch. of Bus. Res. Paper No. 14-21, 2014),

Many mature companies have created standing committees of the board to enhance enterprise risk management efforts.²²⁸ While this topic may appear at first glance to be well beyond the purview of early-stage enterprises, it seems that giving systematic thought to “the worse that can happen” may yield rewards and mean the difference between survival and failure. Bribery and corruption laws, such as the Foreign Corrupt Practices Act or U.K. Bribery Act of 2010 may prove to be an expensive trap for the unwary.²²⁹ While these types of issues may seem esoteric and not on the radar screen of most entrepreneurs, unfortunately they may have the ability to consume and destroy both scarce people and financial resources. Accordingly, sources of material risk should be seriously considered. A crisis environment may prove challenging even for those enterprises having strong, experienced management teams and abundant financial resources. Almost all start-ups, tending to have less of everything, will prove to be much more fragile during a crisis.

EFFICIENT USE OF LEGAL COUNSEL

How can an entrepreneur prepare to make efficient use of legal counsel? First, by doing some homework. It makes little sense to pay lawyers charging on an hourly basis to ask you, while “on the clock,” questions you could have asked yourself if you did some homework. The more the entrepreneur anticipates the information legal counsel will need before giving advice, the more time and money the entrepreneur can save by assembling that information in preparation for working with such counsel. The entrepreneur should engage legal counsel early-on in the venture planning process. Discovering legal issues after committing to a course of action often causes problems that cannot be easily unwound, and generally ends up costing

<http://ssrn.com/abstract=2455983>; Galina M. Vereshchagina & Hugo A. Hopenhayn, *Risk Taking By Entrepreneurs*, 99 AM. ECON. REV. 1808 (2009), <http://ssrn.com/abstract=990928>; Lawrence J. Trautman, *Personal Ethics and the U.S. Financial Collapse of 2008–09*, (forthcoming), <http://ssrn.com/abstract=2502124>; Lawrence J. Trautman, *The Board's Responsibility for Crisis Governance* (Sept. 26, 2014), <http://ssrn.com/abstract=2623219>; Lawrence J. Trautman & Kara Altenbaumer-Price, *D&O Insurance: A Primer*, 1 AM. U. BUS. L. REV. 337 (2012), <http://www.ssrn.com/abstract=1998080>; Lawrence J. Trautman & Kara Altenbaumer-Price, *The Importance of Insurance in Managing Corporate Cyber Threat* (forthcoming) (on file with authors).

²²⁸ See generally Lawrence J. Trautman & Kara Altenbaumer-Price, *The Board's Responsibility for Information Technology Governance*, 28 J. MARSHALL J. COMPUTER & INFO. L. 313 (2011).

²²⁹ See generally Lawrence J. Trautman & Kara Altenbaumer-Price, *The Foreign Corrupt Practices Act: Minefield for Directors*, 6 VA. L. & BUS. REV. 145 (2011), <http://ssrn.com/abstract=1930190>; Lawrence J. Trautman & Kara Altenbaumer-Price, *Lawyers, Guns & Money – The Bribery Problem and U.K. Bribery Act*, 47 INT'L LAW. 481 (2013), <http://ssrn.com/abstract=2276738>; Lawrence J. Trautman & Kara Altenbaumer-Price, *Foreign Corrupt Practices Act: An Update on Enforcement and SEC and DOJ Guidance*, 41 SEC. REG. L.J. 241 (2013), <http://ssrn.com/abstract=2293382>; Gideon Mark, *Private FCPA Enforcement*, 49 AM. BUS. L.J. 419 (2012); Philip M. Nichols, *The Business Case for Complying with Bribery Laws*, 49 AM. BUS. L.J. 325 (2012); Norman D. Bishara, *Governance and Corruption Constraints in the Middle-East: Overcoming the Business Ethics Glass Ceiling*, 48 AM. BUS. L.J. 227 (2011); Peter R. Reilly, *Incentivizing Corporate America to Eradicate Transnational Bribery Worldwide: Federal Transparency and Voluntary Disclosure Under the Foreign Corrupt Practices Act*, __ FLA. L. REV. (forthcoming 2015), <http://ssrn.com/abstract=2585789>; Mike Koehler, *A Foreign Corrupt Practices Act Narrative*, 22 MICH. ST. INT'L L. REV. 961 (2014), <http://ssrn.com/abstract=2428555>; Mike Koehler, *Ten Seldom Discussed Foreign Corrupt Practices Act Facts that You Need to Know*, 10 BLOOMBERG BNA WHITE COLLAR CRIME REPORT 347 (May 1, 2015), <http://ssrn.com/abstract=2601840>; Virginia G. Maurer & Ralph E. Maurer, *Uncharted Boundaries of the U.S. Foreign Corrupt Practices Act*, 20 J. FIN. CRIME 355 (2013); Lawrence J. Trautman, *Entrepreneurial Risk in International Markets: Focus on Bribery and Corruption* (forthcoming)(on file with authors).

more to address than if the associated legal issues were spotted and dealt with early on.²³⁰

CONCLUSION

New business formation is the economic engine that creates jobs. To survive, all successful entrepreneurs must become skillful at optimizing efficiency at every opportunity. In the United States, diverse legal issues such as intellectual property identification and protection, entity choice and formation, taxation, initial capitalization and fundraising (through various sources) in compliance with securities laws, debtor-creditor laws, and employment laws will require finding skilled legal talent.

It is critical to economic recovery and growth that entrepreneurs make the effort to become educated on legal issues their startups will encounter. Entrepreneurs must engage “can do” legal counsel to help navigate them through the various laws and regulations involved, because it is through the business formation process and allocation of capital to deserving enterprises that jobs at all levels are created. All of us owe much to those individuals who (against the odds) risk their finite time and personal net worth in the attempt to create a successful business.

²³⁰ See generally BAGLEY & DAUCHY, *supra* note 9, at 41–48; Thomas C. Brown & Anthony J. Luppino, *How To Be Your Own Lawyer. . . Without Being a Fool: A Practical Guide for the Entrepreneur Who Wants to Save Time and Money through Informed Self-Help, Preparation and the Efficient Use of Legal Counsel*, <http://www.howtobeyourownlawyer.com/about/> (last visited Aug. 18, 2016).

APPENDIX A

COMPLETED KICKSTARTER FUNDED PROJECTS

(As of December 3, 2015)²³¹

Category	Successfully Funded Projects	Less than \$1,000 Raised	\$1,000 to \$9,999 Raised	\$10,000 to \$19,999 Raised	\$20,000 to \$99,999 Raised	\$100 K to \$999,999 Raised	\$1 M Raised
All	97,067	11,484	56,967	13,665	12,350	2,459	142
Music	21,717	2,123	15,707	2,746	1,089	51	1
Film & Video	19,321	2,059	11,163	3,049	2,762	284	4
Publishing	8,411	1,256	5,352	1,078	683	42	0
Art	8,378	1,776	5,412	749	405	34	2
Games	6,815	504	2,647	1,249	1,803	556	56
Design	5,843	389	2,016	1,064	1,786	563	25
Theater	5,334	695	3,959	438	230	12	0
Food	4,465	516	1,882	1,040	974	49	4
Technology	3,736	247	1,086	512	1,150	694	47
Comics	3,414	411	2,119	460	370	53	1

²³¹ KICKSTARTER, *Successfully Funded Projects*, <https://www.kickstarter.com/help/stats?ref=footer> (last viewed July 3, 2016).

2016] SOME KEY THINGS U.S. ENTREPRENEURS NEED TO KNOW 201

Technology	3,736	247	1,086	512	1,150	694	47
Comics	3,414	411	2,119	460	370	53	1
Fashion	3,359	345	1,627	600	681	104	2
Photography	2,436	427	1,440	345	213	11	0
Dance	1,848	171	1,474	156	47	0	0
Crafts	1,266	430	677	95	61	3	0
Journalism	724	135	406	84	96	3	0

AN ORAL AGREEMENT TO SELL GOODS IS ENFORCEABLE UNDER AN EXCEPTION IN U.C.C. § 2.201'S STATUTE OF FRAUDS WHEN THE PARTY AGAINST WHOM ENFORCEMENT IS SOUGHT ADMITS IN PLEADING, TESTIMONY OR OTHERWISE IN COURT THAT A CONTRACT FOR SALE WAS MADE. AN AGGRIEVED BUYER LEARNS OF THE BREACH A COMMERCIALY REASONABLE TIME AFTER LEARNING OF THE SELLER'S ANTICIPATORY REPUDIATION.

By Andrew Lang McKinnon*

Turner v. NJN Cotton Co., 485 S.W.3d 513 (Tex. App.—Eastland 2015, pet. denied).

In *Turner v. NJN Cotton Co.*, the Eastland Court of Appeals (the Court) affirmed the Dawson County District Court's (the Trial Court) judgment on a jury verdict for the buyer and against a producer of cotton for the crop year 2010.¹ Specifically, the Court held that the producer, Larry Turner (Turner), was contractually obligated under an oral forward contract to sell his 2010 cotton crop to the buyer, NJN Cotton Company (NJN).²

I. BACKGROUND

Buyers and producers of cotton typically implement two methods to transact the sale of cotton: "forward contracts" and "sales by bid after harvest."³ Under a sale by forward contract, the producer and buyer agree to the sale and purchase of cotton before it is harvested.⁴ The producer informs the buyer the number of acres available and the number of bales of cotton expected to be produced.⁵ After entering an agreement with a producer, the buyer may enter into subsequent forward contracts with cotton shippers for future delivery.⁶ Alternatively, if no forward contract is executed, the producer will send the harvested cotton to a cotton gin, and the gin will find buyers for it by sending information to potential bidders.⁷

Turner was a cotton producer in Dawson County who regularly contracted with NJN through its owner and operator, Judy Seely (Seely).⁸ This business relationship spanned over a number of years, and each year, Turner and NJN orally agreed to the purchase and sale of Turner's cotton after harvest.⁹ There had been one season where Turner and NJN executed a forward contract, and on that occasion they signed a written contract.¹⁰ In April 2010, Turner

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¹ *Turner v. NJN Cotton Co.*, 485 S.W.3d 513, 517 (Tex. App.—Eastland 2015, pet. denied).

² *Id.* at 519–21.

³ *Id.* at 517.

⁴ *Id.*

⁵ *Id.*

⁶ *Id.*

⁷ *Id.*

⁸ *Id.* at 517.

⁹ *Id.* at 517–18.

¹⁰ *Id.* at 518.

contacted Seely to discuss contracting for the sale of his cotton.¹¹ In this conversation, Turner stated that he would contract the cotton to Seely if the cotton contract price rose to 1400 points over the government loan price per bale.¹² When the price rose to over 1400, Seely and Turner orally agreed for the purchase price of 1400 for Seely's forward purchase of Turner's cotton.¹³ Notably, Turner testified that he understood the effect of the conversation to mean that at the end of the ginning season, Seely "would pay him money and he would deliver the cotton to her."¹⁴ On April 12 after this conversation, Seely filled out a purchase contract form for her records.¹⁵ Although Seely expected Turner to sign her contract, Turner neither requested nor expressed concern for a written contract.¹⁶

In October 2010, Seely sent Sparenberg Gin a list of producers with whom NJN had entered into sale contracts.¹⁷ In November 2010, Sparenberg Gin informed Turner that he was on NJN's list of producers supplying cotton.¹⁸ Suspecting he could get a better purchase price for his cotton, Turner obtained a copy of the contract from Seely so that his attorney could examine it.¹⁹ Turner's attorney sent Seely a letter on November 16, 2010 notifying her that Turner would not be selling his cotton to NJN.²⁰ Seely, however, had already entered into a forward contract with a cotton shipper, Allenberg, partially in reliance on NJN's agreement with Turner.²¹ The Allenberg contract called for NJN to deliver 7,500 bales of cotton, including 896 bales Seely thought she bought from Turner.²² Consequentially, Turner's repudiation of his agreement with NJN partially caused NJN's inability to deliver 1,935 bales to Allenberg.²³ Thereafter, NJN brought suit against Turner alleging breach of contract.²⁴

The jury at trial found that:

Turner failed to comply with the agreement; Turner admitted in his testimony that he contracted with NJN for the sale of his 2010 cotton crop; Turner received confirmation of the contract and had reason to know the contents of it; and Turner did not give written notice of his objections to the contents of the confirmation within ten days after he received it.²⁵

Accordingly, the Trial Court entered a judgment in favor of NJN in accordance with the

¹¹ *Id.*

¹² *Id.*

¹³ *Id.*

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.*

²¹ *Id.* at 518–19.

²² *Id.* at 519.

²³ *Id.*

²⁴ *Id.*

²⁵ *Id.* at 517.

jury verdict.²⁶

II. TEXAS COURT OF APPEALS ANALYSIS

a. An informal agreement may create present and binding obligations.

On appeal, the Court first considered whether there was legally sufficient evidence to support the jury's finding that Turner admitted he and NJN made a contract for the sale of his 2010 cotton to NJN.²⁷ If so, that would prove an exception to the Texas U.C.C. statute of frauds²⁸ and avoid its prohibition.²⁹ The Court noted Seely's testimony that Turner had agreed to sell her his 2010 cotton crop for 1400 over the government loan price, Turner's deposition testimony that he agreed to sell his 2010 cotton crop to Seely for 1400 over the loan price, and testimony by Sammy Stevens that Turner said he had sold his crop to Seely, and the Court found this legally sufficient to remove the contract from the statute of frauds.³⁰

Next the Court considered whether there was sufficient evidence that an enforceable contract existed.³¹ Examining the elements of a valid contract the Court found there was legally sufficient evidence that an enforceable oral contract existed between Turner and NJN, noting that an oral contract exists when there is: (1) an offer; (2) acceptance in strict compliance with the terms of the offer; (3) a meeting of the minds; and (4) each party's consent to the terms.³² The Court indicated it objectively considers circumstantial evidence, including "communications between the parties and the acts and circumstances that surround those communications," to determine whether there was a "meeting of the minds, therefore, an offer and acceptance."³³ The Court noted that the parties' intentions to subsequently reduce an informal agreement to writing does not prevent present [and] binding obligations.³⁴

Accordingly, based on the testimony cited above the Court held there was legally sufficient evidence that there was an enforceable oral contract between Turner and NJN, stating:

There was evidence from which both the jury and the trial court could find that there had been an offer, an acceptance in strict compliance with the terms of the offer, a

²⁶ *Id.* at 519.

²⁷ *Id.*

²⁸ *Id.* at 519. TEX. BUS. & COM. CODE ANN. § 2. 201(c) (West 2009) read:

A contract which does not satisfy the requirements of Subsection (a) but which is valid in other respects is enforceable . . . (2) if the party against whom enforcement is sought admits in his pleading, testimony or otherwise in court that a contract for sale was made, but the contract is not enforceable under this provision beyond the quantity of goods admitted.

²⁹ *Turner*, 485 S.W.3d at 520.

³⁰ *Id.*

³¹ *Id.* at 521.

³² *Id.*

³³ *Id.* (quoting *Palestine Water Well Servs., Inc. v. Vance Sand & Rock, Inc.*, 188 S.W.3d 321, 325 (Tex. App.—Tyler 2006, no pet.)).

³⁴ *Turner*, 485 S.W.3d at 521 (citing *Principal Life Ins. Co. v. Revalen Dev. LLC*, 358 S.W.3d 451, 455 (Tex. App.—Dallas 2012, pet denied)).

meeting of the minds, and consent of each party to the essential terms of the agreement and that those terms constituted a contract between Turner and NJN. We hold that, on the record before us, the trial court did not err when it entered its judgment enforcing the oral contract between Turner and NJN.³⁵

b. Award of damages under U.C.C. § 2.713 for non-delivery of the goods was a permitted remedy, and there was no duty to mitigate by making a covering contract.

Next, the Court considered whether NJN properly pleaded damages under the Texas Business & Commerce Code.³⁶ The Court found that Texas Business & Commerce Code (UCC) provides an aggrieved buyer alternative remedies when a seller fails to deliver goods.³⁷ Explicitly, a buyer may choose to “cover and collect damages,” or “recover damages for non-delivery.”³⁸ Notably, “a buyer is *always* free to choose between ‘cover’ and ‘damages for non-delivery.’”³⁹ In this case, NJN sought damages for non-delivery,⁴⁰ thus NJN had no duty to mitigate by making a covering contract.⁴¹

c. An aggrieved party “learns of the breach” a commercially reasonable time after notification of an anticipatory breach.

The Court indicated that Section 2.713 measures damages for non-delivery as “the difference between the market price [of cotton] at the time when [NJN] learned of the breach and the contract price together with any incidental and consequential damages provided in Section 2.715, less any expenses saved as a result of the breach by the seller.”⁴²

On appeal, the Court considered whether the Trial Court correctly determined the date on which NJN “learned of [Turner’s] breach.”⁴³ This was essential because the date when NJN “learned of the breach” dictated the date to examine the market price of cotton.⁴⁴

The Court examined Section 2.610 of the Texas Business and Commercial and found that during a situation of an anticipatory breach, a buyer may await performance for a commercially reasonable time before they choosing a remedy under Section 2.711.⁴⁵ This allows the breaching party an opportunity to retract the repudiation before the aggrieved party

³⁵ *Turner*, 485 S.W.3d at 521.

³⁶ *Id.* at 523.

³⁷ *Id.*

³⁸ *Id.*; TEX. BUS. & COM. CODE, ANN. §§ 2.711, 2.713(a) (West 2009).

³⁹ *Id.*; *see also* UCC § 2.712(c) and cmt. 3.

⁴⁰ *Id.*

⁴¹ *Id.*

⁴² *Id.*; *see also* UCC § 2.713(a).

⁴³ *Turner*, 485 S.W.3d at 526–27 (noting that the Trial Court considered the market price of cotton during February of 2011 as opposed to November 2010 when Turner’s attorney sent Seely notification that Turner would not sell NJN his cotton.).

⁴⁴ *Turner*, 485 S.W.3d at 527.

⁴⁵ *Id.*; *see also* UCC § 2.610.

decides on a remedy unless the aggrieved party has changed position or otherwise indicated the repudiation to be final.⁴⁶ The Court reasoned that if Section 2.713 stated “learned of the breach” to mean the date from which the seller first communicates the anticipated breach to the buyer, then this would undermine the purpose of Section 2.610.⁴⁷ Accordingly, the Court held that the correct date when an aggrieved buyer “learns of the breach” is “a commercially reasonable time after he learns of the seller’s anticipatory repudiation.”⁴⁸

The Court found that NJN did not wait longer than commercially reasonable after receiving Turner’s notice of repudiation before selecting its remedy.⁴⁹ Evidence at trial indicated that NJN believed Turner would deliver on his oral contract notwithstanding the Turner’s letter sent in November 2010 stating otherwise.⁵⁰ Moreover, Seely testified that based on her prior dealings with Turner, she believed he would deliver under his oral contract because he had always done so.⁵¹ The Court found it was not until February 2011 that Seely “finally realized that Turner was not going to deliver.”⁵² Consequentially, with all the information made available to her in February of 2011, she concluded that Turner had breached their contract.⁵³ Thereafter, Seely sent Turner’s attorney a demand letter.⁵⁴ Thus, the Court held that NJN and Seely learned of the breach in February of 2011, applying the February market price of cotton accordingly.

d. Other evidence and procedural issues considered by the Court are omitted from this discussion as irrelevant.

There was no evidence offered to support a claim for tortious interference with contract or tortious interference with a prospective business relationship, thus the jury charge properly omitted such claims as well as certain definitions requested by Turner, and attorney fees were properly awarded to NJN.⁵⁵

III. CONCLUSION

Practitioners should be cognizant of the parties’ conduct surrounding a possible sale of goods. The *Turner* case illustrates that while parties may not formally contract in writing for a sale of goods, their communications and actions may give rise to present and binding

⁴⁶ *Id.*; see also UCC § 2.611(a).

⁴⁷ *Turner*, 485 S.W.3d at 527 (stating that the buyer may await performance for a commercially reasonable time).

⁴⁸ *Id.* (citing *Cosden Oil & Chem. Co. v. Aktiengesellschaft*, 736 F.2d 1064, 1072 (5th Cir. 1984)).

⁴⁹ *Turner*, 485 S.W.3d at 527.

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² *Id.*

⁵³ *Id.*

⁵⁴ *Id.*

⁵⁵ *Turner*, 485 S.W.3d at 523–28. The Court noted that although attorney fees are normally segregated by recoverable and unrecoverable amounts, “when discrete legal services advance recoverable and unrecoverable claims that are so intertwined, it is not necessary to segregate the fees in order to recover the entire amount.” *Id.* at 528 (citing *Verner v Cardenas*, 218 W.3d 68, 69 (Tex. 2007) (holding that fees incurred while defending against defenses and counterclaims during a recovery on contract are “recoverable,” and need not be segregated)).

obligations. These informal, oral contracts may not be evident initially, but courts consider circumstantial evidence as aforementioned to find whether an agreement was made. In addition, the *Turner* case interpreted UCC Section 2.610 to mean that an aggrieved buyer “learns of the breach” after a “commercially reasonable time from the anticipatory breach.” While drafting the damages model, practitioners should be aware that the applicable market price of goods may differ from the time an aggrieved party anticipates the breach, and instead be when it finally learns of the breach.

LIBEL AND SLANDER—PRIVILEGE IN REPORTS REGARDING POSSIBLE CRIMINAL ACTIVITY

By Joseph Ty Vessels*

Shell Oil Co. v. Witt, No. 13-0552, 2015 WL 2328678 (Tex. May 15, 2015).

In *Shell Oil Co. v. Witt*, the Texas Supreme Court grappled with the question of whether providing a report regarding possible criminal activity to a government agency was an absolutely privileged communication or a conditionally privileged communication.¹ The court would determine that the report was given under the specter of impending litigation and should be absolutely privileged.² In order to reach this conclusion, the court considered public policy, and compared and contrasted case law.³

In 2007 The Department of Justice (DOJ) began an investigation involving a possible violation of the Foreign Corrupt Practices Act (FCPA) by Shell Oil Company (Shell) and Shell's employee Robert Witt.⁴ Witt served as the contract holder and expense manager between Shell and Vecto Gray.⁵ Gray had recently pled guilty to bribing a Nigerian official through a freight forwarding and customs clearing company known as Panalpina, Inc.⁶ Panalpina was used to import equipment for Shell's deep-water oil and gas project off the coast of Nigeria—the Bonga Project.⁷ Shell received a letter from the DOJ approximately five months after Gray's conviction revealing the DOJ had become aware that certain services Panalpina provided Shell may have violated the FCPA.⁸

The DOJ identified several witnesses and persons of interest, one of which was Shell employee Robert Witt.⁹ Shell agreed to conduct an internal investigation on its dealings with Panalpina.¹⁰ Witt was questioned several times about his knowledge of Panalpina's possible illegal payments.¹¹ Shell provided the DOJ their finished report in February 2009.¹² The report stated that Witt's actions in relation to the Bonga project had violated Shell's General Business Principles and Code of Conduct, finding Witt was aware of several red flags in Panalpina's customs clearance process and that Witt provided inconsistent knowledge of the suspect actions.¹³ Witt, in turn, sued Shell for defamation and wrongful termination.¹⁴ He

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¹ *Shell Oil Co. v. Witt*, No. 13-0552, 2015 WL 2328678, at *1 (Tex. May 15, 2015).

² *See id.* at *8.

³ *See id.* at *5–8.

⁴ *Id.* at *1.

⁵ *Id.*

⁶ *Id.*

⁷ *Id.*

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.*

¹¹ *Id.*

¹² *Id.*

¹³ *Id.*

¹⁴ *Id.* at *2.

argued Shell falsely accused him of approving bribery payments and participating in illegal conduct.¹⁵ Shell responded with a motion for summary judgment based on the grounds of absolute privilege.¹⁶ The DOJ then filed an information charging Shell with conspiracy to violate the FCPA, arguing Shell aided in the making of false books and records, while the motion for summary judgment was still pending.¹⁷ Shell acquiesced to a deferred prosecution agreement in which the DOJ acknowledged that Shell cooperated in the investigation, agreed to further ongoing investigations, and agreed to pay a reduced fine.¹⁸

Afterwards, the district court granted Shell's motion for summary judgment, holding that Shell was absolutely privileged to provide the investigative report to the DOJ.¹⁹ Writt's wrongful termination claim proceeded to trial where a jury found for Shell.²⁰ Writt appealed only the summary judgment on his defamation claim.²¹ The court of appeals reversed the district court's ruling, holding that the evidence did not conclusively establish a criminal judicial proceeding against Shell, or Writt, was ongoing at the time Shell provided its report to the DOJ.²² Therefore, the report was only conditionally privileged, rather than absolutely privileged.²³ In response, Shell argued absolute privilege extends to the report because it was given to the DOJ under the veil of an eminent judicial proceeding.²⁴ Furthermore, Shell argued the information about Writt in the report was solicited by the DOJ during an ongoing FCPA investigation.²⁵ Shell asserted it compiled and provided the report in good faith contemplation of a judicial proceeding and the facts are adequate to provide a holding for absolute privilege.²⁶ Shell relied upon the precedent in *Hurlbut v. Gulf Atlantic Life Insurance Co.*, 749 S.W.2d 762, 768 (Tex.1987) and *Hurlbut's* contrasting circumstances to support its position.²⁷ In *Hurlbut* the alleged defamatory statements were unsolicited statements not instigated by a government investigation and, thus, only conditionally privileged.²⁸ Shell, on the other hand, was a target of a criminal investigation and solicited the report and information to the DOJ at the urging of the DOJ.²⁹ Writt argued that the court of appeals was correct in its classification of the information as conditionally rather than absolutely privileged and that the summary judgment evidence was not enough to establish the DOJ had progressed to prosecution by the time Shell provided the report.³⁰

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.*

²¹ *Id.*

²² *Writt v. Shell Oil Co.*, 409 S.W.3d 59, 76 (Tex. App.—Houston [1st Dist.] 2013).

²³ *Id.*

²⁴ *Shell Oil Co.*, 2015 WL 2328678, at *3.

²⁵ *Id.*

²⁶ *Id.*

²⁷ *Id.*

²⁸ *Hurlbut v. Gulf Atlantic Life Ins. Co.*, 749 S.W.2d 762, 768 (Tex. 1988).

²⁹ *Shell Oil Co.*, 2015 WL 2328678, at *3.

³⁰ *Id.*

Full and free disclosure of information as to criminal activity is essential for the proper functioning of the justice system.³¹ For that reason, Texas recognizes absolute and conditional privileges concerning defamation suits.³² The Texas Supreme Court has held an absolute privilege arises for the communications of a witness when such communications occur before a judicial proceeding or as part of a judicial proceeding, as long as the information has some relation to the proceeding.³³ This test is comprised of objective and subjective components.³⁴ An actual formal proceeding does not eventually have to occur.³⁵ However, the possibility of a proceeding must have been a serious possibility.³⁶ To that end, Texas has recognized absolute privilege for communications given in quasi-judicial proceedings and scenarios where the benefit of the communication to the general public outweighs the harm to an individual.³⁷

The court held that the rule of law above, affirmed in *Hurlbut*, was applicable in Shell's case.³⁸ *Hurlbut* involved two insurance agents, C. Daniel Hurlbut and A.C. Hovater, who formed an insurance agency to sell group insurance policies from Gulf Atlantic Insurance Company.³⁹ However, state approval was never obtained by Gulf.⁴⁰ Gulf was to obtain regulatory approval in order to underwrite, and therefore, Hurlbut did not have a master exemplar policy to present to clients.⁴¹ Gulf's representative encouraged Hurlbut to proceed with the sales anyway when confronted by Hurlbut and Hovater.⁴² When questioned by a city attorney regarding said policy, Hurlbut referred him to Gulf for confirmation.⁴³ Gulf revealed it was not underwriting the policy and Assistant Attorney General Bill Flanary was assigned to investigate Hurlbut and his agency.⁴⁴ After a meeting with Gulf's president, William Barnes, Flanary became certain that Hurlbut's actions were illegal.⁴⁵ At a meeting between the three parties, Barnes reiterated that Hurlbut was not authorized by Gulf to market a group policy, nor was Gulf involved with said policy.⁴⁶ Flanary then took Hurlbut to the Dallas Attorney General's office where he gave statements about the group policy.⁴⁷ When Barnes was told that Gulf might be the true culprit, Gulf immediately cut off communications.⁴⁸ Following

³¹ *See id.*

³² *Id.*

³³ *See Hurlbut*, 749 S.W.2d at 768.

³⁴ *See* Restatement (Second) of Torts § 588 cmt. e (1977).

³⁵ *Id.*

³⁶ *Id.*

³⁷ *Shell Oil Co.*, 2015 WL 2328678, at *4; *Bird v. W.C.W.*, 886 S.W.2d 767, 771 (Tex. 1994); *see also* *Reagan v. Guardian Life Ins. Co.*, 166 S.W.2d 909, 913 (Tex. 1942).

³⁸ *Shell Oil Co.*, 2015 WL 2328678, at *6.

³⁹ *Hurlbut*, 749 S.W.2d at 763.

⁴⁰ *Id.*

⁴¹ *Id.* at 763–64.

⁴² *Id.*

⁴³ *Gulf Atlantic Life Ins. Co. v. Hurlbut*, 696 S.W.2d 83, 89–90 (Tex. App.—Dallas 1985).

⁴⁴ *Id.* at 90.

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ *Id.*

these events, Hurlbut's assets were seized and liquidated, his insurance license revoked.⁴⁹ Hurlbut sued Gulf on several claims, including business disparagement.⁵⁰ The trial court ruled in favor of Hurlbut, however, the court of appeals reversed holding that false statements made by Barnes during the meeting where Hurlbut was present were absolutely privileged because evidence established that the statements were made to Mr. Flanary, a public official, during a quasi-judicial proceeding.⁵¹ The Texas Supreme court concluded that the statements were more akin to persons communicating information of public interest to a public officer or private citizen authorized to take action if the information is true, rather than a testimony of a witness at a judicial proceeding.⁵² Therefore the information was only conditionally privileged.⁵³ However, the facts and communications differed from those of Shell's resulting in the categorization of Shell's report as absolutely privilege.⁵⁴

Hurlbut is not the only case that has asked a Texas court to consider the question of privilege. For example, in *Clemens v. McNamee*, a federal district court ruled that statements by a witness in an investigation of money laundering and the distribution of illegal substances was privileged due to public policy concerns involved in compelled confession.⁵⁵ The court in *Clemens* believed that had conditional privilege been applied to the statements, the government's ability to assure that justice was served would have been harmed.⁵⁶ The witness in *Clemens*, Brian McNamee, was interviewed by a special commission.⁵⁷ McNamee was told that if he did not fully cooperate with the commission his status as a witness would be reassessed.⁵⁸ Assistant United States Attorneys attended every interview.⁵⁹ McNamee voluntarily gave information, but because of the coercive circumstances, the court held for all intents and purposes he was in fact compelled to make such statements.⁶⁰ Therefore, the information was held to be absolutely privileged.⁶¹

The court in *Shell Oil*, using *Hurlbut* and *Clemens* as its guide, applied the law from *Hurlbut* but likened Shell's facts and circumstances to those in *Clemens*.⁶² Where Gulf was not the target of the Assistant Attorney General's investigation at all times, evidence established that Shell Oil was the clear target of the DOJ during the DOJ's entire involvement much like McNamee was a constant target throughout the investigation.⁶³ The court found even more distinguishable the fact that Gulf completely cut off all communications whereas Shell did

⁴⁹ *Hurlbut*, 749 S.W.2d at 764.

⁵⁰ *Id.* at 763.

⁵¹ *Gulf Atlantic*, 696 S.W.2d at 100.

⁵² *Hurlbut*, 749 S.W.2d at 767–68.

⁵³ *Id.* at 768.

⁵⁴ *Shell Oil Co.*, 2015 WL 2328678, at *6.

⁵⁵ *Clemens v. McNamee*, 608 F.Supp.2d 811, 824–25 (S.D. Tex. 2009).

⁵⁶ *Id.* at 825.

⁵⁷ *Id.* at 824.

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ *Id.*

⁶¹ *Id.* at 825.

⁶² *Shell Oil Co.*, 2015 WL 2328678, at *7.

⁶³ *Id.* at 7–8.

not.⁶⁴ The constant communication between Shell and the DOJ was clear evidence that Shell was a continuous target for the DOJ. In addition, when viewing the severity of the penalties levied against Shell, it was apparent that Shell was compelled to undertake its investigation, much like McNamee was compelled to make statements in *Clemens*.⁶⁵ The court explained the manner of FCPA enforcement was steadily becoming more coercive as time progressed between the DOJ's first contact with Shell Oil and the furnishing of the report.⁶⁶ This heightened the compelled nature of the report.⁶⁷ The court supported the coercive nature of the DOJ using an article from this very journal, *The Texas Journal of Business Law*, which revealed many companies choose to cooperate to obtain any chance at leniency from the government's harsh penalties.⁶⁸ The looming shadow of the DOJ was to Shell as the federal marshals, threats, and the special commission were to McNamee in *Clemens*.⁶⁹ Not only was the threat of coercion present, the threat of harsher penalties and fines was a direct cause of Shell's creation of the report.⁷⁰

In conclusion, the court held that the summary judgement evidence was conclusive to establish that when Shell furnished the report, Shell was the target of a DOJ investigation.⁷¹ Furthermore, the evidence also established Shell acted under the influence of eminent prosecution.⁷² These circumstances resulted in the court classifying the report as absolutely privileged.⁷³ The court, therefore, reversed the judgement of the court of appeals and reinstated that of the trial court.⁷⁴

⁶⁴ *Id.* at 8.

⁶⁵ *Id.*

⁶⁶ *Id.*

⁶⁷ *See id.*

⁶⁸ See Joel Androphy & Ashley Gangour, *The Intersection of the Dodd-Frank Act and the Foreign Corrupt Practices Act: What All Practitioners, Whistleblowers, Defendants, and Corporations Need to Know*, 45 *Tex. J. Bus. L.* 129, 138 (2013).

⁶⁹ *See Shell Oil Co.*, 2015 WL 2328678, at *8.

⁷⁰ *See id.* at *2.

⁷¹ *Id.* at *8.

⁷² *Id.*

⁷³ *Id.*

⁷⁴ *Id.*

A COURT'S AUTHORITY TO DETERMINE ARBITRABILITY BY LOOKING AT THE RELEVANCE OF AN UNDERLYING CONTRACT TO A CLAIM

By Andrea De La Rosa*

Douglas v. Regions Bank, 757 F.3d 460 (5th Cir. 2014).

It is for a court to determine gateway questions in arbitration.¹ However, the contractual nature of an arbitration agreement that requires the parties' intent was reinforced in *First Option of Chicago v. Kaplan*,² where the Court enforced the parties contractual agreement to have arbitrability determine by an arbitrator so long as there was "clear and unmistakable evidence" that the parties did so agree.³ The Court enforced the contractual aspects of an arbitration agreement even when the validity of the underlying agreement is in question, requiring that a party specifically challenge the delegation clause in order to revert the question of arbitrability back to the court.⁴ In *Douglas v. Regions Bank*,⁵ the fifth circuit adopts a test that addresses the extent of the scope of a delegation clause in an arbitration agreement when the underlying agreement and the disputing claims have no connection.⁶

FACTS AND ISSUES

On August 2002, Shirley Douglas opened a checking account with Union Planters Bank ("Union").⁷ At this time, Douglas signed a signature card agreeing to the terms of a Deposit Account Agreement and Disclosure, which contained the arbitration provision.⁸ The terms of the arbitration provision included a delegation clause.⁹ On May 2003, Douglas closed her

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¹ *First Option of Chicago v. Kaplan*, 514 U.S. 938 (1995).

² *Id.*

³ *Id.*

⁴ *AT&T Techs. v. Communs. Workers of Am.*, 475 U.S. 643 (1986); *Rent-A-Center West Inc. v. Antonio Jackson*, 130 S.Ct. 2772 (2010) (addressing the "separability" doctrine).

⁵ *Douglas v. Regions Bank*, 757 F.3d 460 (5th Cir. 2014).

⁶ *Id.*

⁷ *Id.* at 461.

⁸ *Douglas v. Trustmark Nat'l Bank*, No. 3:12CV523-LG-FKB, 2012 WL 5400040, at *2 (S.D. Miss. Nov. 5, 2012). The arbitration agreement stated as follows:

by using or maintaining your account, you agree, that in the event of any dispute, disagreement, claim or controversy . . . between you and us or any of our agents or employees, or our parent, subsidiary or sister corporations or their employees or agents, . . . will, at the election of you or us, be resolved through the process of binding arbitration.

Id. at 462, n.3.

⁹ *Douglas v. Regions Bank*, 757 F.3d at 461. The arbitration agreement's definition of "dispute" contains the delegation clause, as italicized below:

"Dispute" means . . . any claim, controversy or dispute arising from or relating in any way to (i) this Agreement, (ii) any related agreement (iii) any agreement that this Agreement super[s]edes, [and] (iv) the relationships, accounts or balances on the accounts resulting from this Agreement or such other agreements, *including the validity, enforceability, or scope of this Arbitration provision or any amendments or supplements to this Agreement.*

account with Union.¹⁰ In June 2005, Union merged with Regions Bank (“Regions”).¹¹

In 2007, Douglas was in an automobile accident due to the negligence of the other driver, and obtained a settlement for \$500,000.¹² In 2010, Douglas began to have financial difficulties and file a petition for relief pursuant to Chapter 13 of the United States Bankruptcy Code.¹³ In order to obtain payment, Douglas’s attorney in her personal injury suit hired Vann Leonard to have the \$500,000 settlement approved in bankruptcy court.¹⁴ Subsequent to the bankruptcy court approving the settlement, it entrusted the settlement funds to Leonard.¹⁵ Leonard disbursed payment to Douglas’s personal injury attorney and embezzled the rest of the settlement.¹⁶ During these events, Leonard maintained client trust accounts with Regions and Trustmark National Bank (“Trustmark”).¹⁷ In 2012, Douglas sued Regions and Trustmark¹⁸ “for negligence and conversion on the grounds that they had notice of [Leonard’s] embezzlement and negligently failed to report that activity.”¹⁹

Regions filed a motion to compel arbitration and stay the proceedings, making two arguments, (1) that Douglas’s agreement to arbitrate any dispute with Union was still in effect, and (2) the determination of arbitrability must be submitted to the arbitrator as per the arbitration provision in the signature card.²⁰ Douglas claimed that she never agreed to arbitrate her dispute with Regions when she agreed to the arbitration provision in Union’s signature card, and for that reason, the question of arbitrability could be addressed by the court.²¹

The district court denied Regions’s motion stating that under Mississippi state law the parties did not have an agreement to arbitrate because a non-signatory (Regions) cannot invoke an arbitration agreement entered into by its predecessor.²² It further stated that Regions did not have other grounds to enforce the arbitration provision—such as equitable estoppel—because the issue at hand did not related to the underlying agreement that contained the arbitration

Id. at 462, n.3. The arbitration agreement further contains a survival clause—referenced by the dissent—that stated the arbitration agreement would remain effective and was irrevocable, even if Douglas closed her account(s) with Union. *Douglas*, 2012 WL 5400040, at *3.

¹⁰ *Douglas*, 2012 WL 5400040, at *3.

¹¹ *Douglas v. Regions Bank*, 757 F.3d 460, 461 (5th Cir. 2014).

¹² *Id.* at 461.

¹³ *In re Douglas*, No. 09-13893-DWH, 2011 WL 832501, at *1 (Bankr. N.D. Miss. Mar. 3, 2011).

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *Douglas*, 2012 WL 5400040, at *3–4.

¹⁸ “The district court stayed proceedings with Trustmarks pending conclusion of any arbitration proceedings between Douglas and Regions.” *Douglas*, 757 F.3d at 461, n.1.

¹⁹ *Id.*

²⁰ *Douglas v. Trustmark Nat’l Bank*, No. 3:12CV523–LG–FKB, 2012 WL 5400040, at *4 (S.D. Miss. Nov. 5, 2012).

²¹ *Id.*

²² *Douglas*, 757 F.3d at 461–62. The fifth circuit court of appeals addressed the district court’s improper application of state law, *see id.* at 462, n.2, and asserted that an agreement to arbitrate did exist between Douglas and Regions. *Id.* at 462.

provision.²³ Regions appealed the decision.²⁴

On appeal, Douglas stated that she was not challenging Regions's rights as Union's successor-in-interest.²⁵ Rather, Douglas challenged the lack of relevance between the underlying contract to the arbitration agreement and her dispute with Regions.²⁶ The court of appeals addressed the issue of whether the arbitration agreement and its delegation clause were relevant to the dispute at hand.²⁷

LAW & APPLICATION

The court held that even though the arbitration provision had a delegation clause, Regions's averment that Douglas's dispute with Regions fell within the scope of the arbitration provision was wholly groundless.²⁸ The court explains that a delegation clause is an agreement to have an arbitrator determine "gateway questions of arbitrability, such as . . . whether the . . . agreement covers a particular controversy."²⁹ However, the agreement to arbitrate arbitrability must be "clearly and unmistakably" stated in the parties' agreement, otherwise the determination is for the court.³⁰ If there is clear and unmistakable evidence of the parties' intent, the court stated that the existence of a delegation clause requires "an arbitrator to decide in the first instance whether a dispute falls within the scope of the arbitration provision."³¹ Nevertheless, an arbitration agreement with a delegation clause "cannot . . . bind [a party] to arbitrate gateway question of arbitrability in all future disputes with the other party, no matter the origin."³²

In coming to its holding, the court analyzed the federal circuit's two prong-test in *Qualcomm Inc. v. Nokia Corp.*³³ and the federal circuit's elaboration of the test in *InterDigital Commc'n, LLC v. Int'l Trade Comm'n.*³⁴ The court stated that when an arbitration agreement has a delegation clause it does not automatically require that a claim to be sent to gateway arbitration.³⁵ The court noted that in its previous decision, *Agere Systems, Inc. v. Samsung Electronic Co.*,³⁶ it addressed a similar question, and although the facts of the case did not

²³ *Douglas*, 2012 WL 5400040, at *17–18.

²⁴ *Douglas*, 757 F.3d at 461.

²⁵ *Id.* at 461–62.

²⁶ *Id.* at 462.

²⁷ *Id.*

²⁸ *Id.* at 464.

²⁹ *Id.* at 462 (citing *Rent-A-Center W., Inc. v. Jackson*, 561, U.S. 63 (2010)) (internal quotes removed).

³⁰ *Id.* (citing *First Options of Chicago Inc. v. Kaplan*, 514 U.S. 938, 944 (1995)).

³¹ *Id.* at 462.

³² *Douglas*, 757 F.3d at 462.

³³ *Qualcomm Inc. v. Nokia Corp.*, 466 F.3d 1366 (Fed. Cir. 2006).

³⁴ *InterDigital Commc'n, LLC v. Int'l Trade Comm'n.*, 718 F.3d 1336 (Fed. Cir. 2013).

³⁵ *Douglas*, 757 F.3d at 463.

³⁶ *Agere Systems, Inc. v. Samsung Electronic Co.*, 560 F.3d 337 (5th Cir. 2009). In *Agere*, the parties entered into an arbitration agreement that contained a delegation clause and subsequently entered into another agreement that did not contain the arbitration agreement. *Id.* 338–39. The court followed precedent that in "resolving doubts concerning coverage of a broadly worded arbitration clause," federal policy is in favor of arbitration. *Id.* at 340. The court decided to send the gateway question to the arbitrator because there was a legitimate possibility that the matter

present the need to adopt the *Qualcomm* test, its holding in *Agere* implicitly relied on it.³⁷

The court noted that the *Qualcomm* test reflects the importance of the parties' intent in agreeing what matters should be arbitrated.³⁸ The *Qualcomm* test requires that the question of arbitrability to be addressed by the court if (1) there is a delegation clause in the arbitration provision; and (2) "the averment that the claim falls within the scope of the arbitration agreement is wholly groundless."³⁹ The test allows a court to stay a proceeding when the parties have clearly agreed to arbitrate arbitrability, "while also preventing a party from asserting any claim at all, no matter how divorced from the parties' agreement, to force an arbitration."⁴⁰ This test allows the court to make a more limited inquiry to determine if the claim of arbitrability is "wholly groundless."⁴¹ This limited inquiry requires that the court "examine and . . . construe the underlying agreement" and determine its relevance to a dispute at hand.⁴²

The court stated that it must give deference to the parties' contractual intent in entering into an arbitration agreement.⁴³ The court held that the parties did agree to arbitrate the gateway question and focused on the second part of test, whether the arbitrability claim is "wholly groundless."⁴⁴ Although it was evident that the parties intended to have arbitrability determined by an arbitrator, there was doubt as to the parties' intent to have all disputes, including those unrelated to the underlying contract, to be arbitrated.⁴⁵

In examining and construing Douglas and Union's underlying agreement, the court questions whether Douglas intentions were to enter an arbitration agreement for all disputes relating to Union (or its successors) regardless of the relevancy of the dispute to the signature card.⁴⁶ The court analyzed the events that lead "to Douglas's claim[s] against Regions"—a car accident, settlement, embezzlement from an account" held by a third-party—and concluded that Douglas's claims had nothing to do with the checking account she maintained with Union several years prior to this dispute.⁴⁷ The court dismissed Regions's argument that the arbitrability claim was not "wholly groundless" because the arbitration provision contained a delegation clause, stating that such assertion was circular and redundant.⁴⁸

should be arbitrated. *Id.*

³⁷ *Douglas*, 757 F.3d at 464.

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ *Douglas*, 757 F.3d at 463 (citing *InterDigital Commc'n, LLC v. Int'l Trade Comm'n.*, 718 F.3d 1336 (Fed. Cir. 2013)).

⁴¹ *Id.*

⁴² *Id.*

⁴³ *Id.* at 464.

⁴⁴ *Douglas*, 757 F.3d at 464.

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ *Id.*

DISSENT

The dissent asserted that the application and adoption of the *Qualcomm* test was improper and contrary to the Supreme Court's authority.⁴⁹ The dissent noted that the Supreme Court has upheld delegation clause created by agreement between the parties to arbitrate the scope of an arbitration provision, so long as it is "sufficiently clear and unmistakable" that that was their intent.⁵⁰ Douglas did not dispute the existence of an arbitration agreement, or specifically challenged the delegation clauses, she argued that her claims against Regions were outside the scope of the arbitration provision, and, therefore, the claims were not subject to the arbitration provision.⁵¹ According to the dissent, the purpose of agreeing to a delegation clause is to address whether a claim is within the scope of an arbitration agreement.⁵²

Douglas argued that "the FAA requires that there be a connection between her dispute with Regions and the Agreement's arbitration provision."⁵³ Whereas, New York's arbitration statute allowed any subsequent disputes between the parties to be arbitrated despite the relevance of the dispute to the parties' contract.⁵⁴ The dissent addressed Douglas's comparison argument of the FAA and the New York arbitration statute the FAA was modeled after, by noting there is no other authority to support her interpretation of the statutes.⁵⁵ Rather, the dissent stated, the Supreme Court has made it clear that the parties must specifically challenge the delegation clause, and not the arbitration provision as a whole, in order to return the question of arbitrability back to the court.⁵⁶ Consequently, the dissent stated that Douglas's failure to challenge the delegation clause would require that an arbitrator determine the arbitrability question.⁵⁷

Further, the dissent focused on the language of the arbitration provision which stated that the agreement would remain effective and was irrevocable even after Douglas closed her account with Union.⁵⁸ The dissent asserted that entering into an arbitration agreement does not obligate the parties to arbitrate any and all of their subsequent disputes, regardless of the connection between the dispute and the arbitration agreement.⁵⁹ Instead, the dissent explained that when the parties have entered into an agreement to arbitrate arbitrability, they should be bound by that agreement.⁶⁰

The dissent stated that the fifth circuit did not adopt the *Qualcomm* test in its *Agere*

⁴⁹ *Id.* (Dennis, J., dissenting).

⁵⁰ *Id.* at 465–66 (Dennis, J., dissenting) (citing *Rent-A-Center, W., Inc. v. Jackson*, 561 U.S. 63).

⁵¹ *Id.* at 466 (Dennis, J., dissenting).

⁵² *Id.* (Dennis, J., dissenting).

⁵³ *Id.* (Dennis, J., dissenting).

⁵⁴ *Id.* at 466–76 (Dennis, J., dissenting).

⁵⁵ *Douglas*, 757 F.3d at 467 (Dennis, J., dissenting).

⁵⁶ *Id.* at 467 (Dennis, J., dissenting) (citing *Rent-A-Center, W., Inc. v. Jackson*, 561 U.S. 63, *First Option of Chicago v. Kaplan*, 514 U.S. 938 (1995)).

⁵⁷ *Id.* (Dennis, J., dissenting).

⁵⁸ *Id.* at 465 (Dennis, J., dissenting), *supra* accompanying text to note 9.

⁵⁹ *Id.* at 467 (Dennis, J., dissenting).

⁶⁰ *Id.* (Dennis, J., dissenting).

decision, but rather, only addressed it in acknowledgment of the parties' claims on appeal.⁶¹ The dissent explained that the test is contrary to *AT&T Mobility LLC v. Commc'ns Workers of Am.*,⁶² where the Supreme Court held that when a court is to address arbitrability of a claim it cannot look at the potential merits of the underlying claim, but must look solely at the parties' agreement to submit the claim to arbitration.⁶³ In *First Option*, the Supreme Court held that once the court has found that the parties agreed to a delegation clause, the court "must defer to an arbitrator's arbitrability decision."⁶⁴ The dissent asserted that, in following *AT&T* and *First Option*, once a court has found that there is a delegation clause the question of arbitrability should be submitted to the arbitrator, and the court must not consider the merits of the dispute.⁶⁵ The dissent noted that the second part of *Qualcomm* test requires a court to look at the merits of a claim in order to determine whether a claim of arbitrability is wholly groundless. This requirement, therefore, is contrary to precedent.

CONCLUSION

In adopting the *Qualcomm* test, the fifth circuit gives the courts the opportunity to look into the parties underlying contract to determine if the question of arbitrability is wholly groundless. A party cannot bind another party to arbitrate all disputes that arise between the parties when the dispute has no connection to the underlying contract for which the arbitration agreement is created, even though the parties have agreed to arbitration. The parties agreeing to have an arbitrator determine arbitrability—a delegation clause—is limited by what a court interprets to be a grounded claim in relation to the reason the parties entered into the agreement. Put simply, the test gives courts the authority to look at the merits of a claim in order to determine if it has any connection to the underlying contract that contains the arbitration provision, regardless of whether the parties agreed to leave the gateway question of arbitrability to the arbitrator.

⁶¹ *Id.* (Dennis, J., dissenting).

⁶² *AT&T Techs. v. Commc'ns. Workers of Am.*, 475 U.S. 643 (1986).

⁶³ *Douglas*, 757 F.3d at 468 (Dennis, J., dissenting).

⁶⁴ *Id.* (Dennis, J., dissenting).

⁶⁵ *Id.* (Dennis, J., dissenting).

WHAT IS THE SCOPE AND EFFECT OF THE COPYRIGHT ACT'S PREEMPTION OF A STATE LAW CLAIM FOR THEFT OR MISAPPROPRIATION OF TRADE SECRETS? WHAT EVIDENCE IS INSUFFICIENT TO AVOID SUMMARY JUDGMENT IN FAVOR OF THE DEFENDANT?

By Rebecca Todd*

Spear Mktg. v. BancorpSouth Bank, 791 F.3d 586 (5th Cir. 2015).

BACKGROUND

In 2015, the United States Court of Appeals for the Fifth Circuit (“Fifth Circuit”) held that the preemption provision of the federal Copyright Act¹ preempted state law claims based on ideas fixed in tangible media, including the plaintiff’s technical trade secrets.² Spear Marketing, Inc. (“SMI”) created cash management software called VaultWorks, which it licensed to BancorpSouth Bank (“Bancorp”) from 2002 to 2012.³ VaultWorks was developed by SMI to optimize the amount of cash a banking institution needs on hand at its branch and ATM locations.⁴ However, SMI’s customers did not have access to the VaultWorks software itself.⁵ Instead, SMI customers logged on to internet user interface screens to manually enter data and receive cash management reports.⁶

In 2012, Bancorp did not renew its agreement with SMI, choosing to license new cash management software developed by ARGO Data Resource Corporation (“ARGO”).⁷ Similar to SMI, ARGO develops software for the banking industry and developed its own cash management system, Cash Inventory Optimization (“CIO”).⁸ However, unlike VaultWorks, CIO is installed directly on the bank’s computers and integrated with the rest of the bank’s operating system.⁹ CIO essentially eliminates the need for the bank’s personnel to manually input cash data.¹⁰ SMI claimed that ARGO created CIO by using SMI’s trade secrets from its own cash management software.¹¹

PROCEDURAL HISTORY

SMI filed its case in Texas state court, alleging theft and misappropriation of trade secrets,

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¹ 17 U.S.C. § 301(a) (2014).

² Spear Mktg. v. BancorpSouth Bank, 791 F.3d 586, 597 (5th Cir. 2015).

³ *Id.* at 589, 591.

⁴ *Id.* at 589–90.

⁵ *Id.* at 590.

⁶ *Id.*

⁷ *Id.* at 591.

⁸ Spear Mktg., 791 F.3d at 590.

⁹ *Id.*

¹⁰ *Id.*

¹¹ *Id.* at 591.

conversion, fraud, and breach of contract, among other causes of action.¹² The case was removed to federal court on the basis of copyright preemption because SMI's primary claims centered on ARGO copying the Vaultworks software.¹³ SMI subsequently amended its state court petition, removing its conversion claim and references to copying and distribution.¹⁴ SMI then argued that removal had been improper because none of its claims should be preempted.¹⁵ The district court denied SMI's motion, holding that the conversion and theft claims were completely preempted.¹⁶ The court did not consider whether the rest of SMI's claims were preempted, but chose to exercise supplemental jurisdiction over them pursuant to 28 U.S.C. § 1367 (2014).¹⁷ The district court granted full summary judgment in the defendants' favor, holding that SMI had no proof that its trade secrets were used.¹⁸ SMI appealed, challenging federal jurisdiction, and the Fifth Circuit affirmed.¹⁹

The district court considered SMI's motion to remand by evaluating the Original Petition for grounds for removal.²⁰ SMI alleged that the district court should have considered SMI's amended complaint where SMI dropped its conversion claim and deleted language regarding copying.²¹ Defendants countered that the removal was measured according to the time-of-filing rule.²² The Fifth Circuit concluded that the district court was correct to consider the Original Petition when deciding SMI's motion to remand.²³ SMI's motion sought remand under 28 U.S.C. § 1447(c) and argued that removal had been improper; therefore, the relevant record was the Original Petition not the one that was changed to exclude copyright language.²⁴

The Fifth Circuit then looked to whether the Original Petition provided a basis for federal jurisdiction and determined that theft of an idea fixed in a tangible medium falls within the subject matter preempted by federal copyright law.²⁵ A two-part test was used when determining if the Copyright Act preempts a state law claim: (1) whether the claim falls within the subject matter of copyright law, and (2) whether the rights protected by the asserted claim are equivalent to the exclusive rights of federal copyright.²⁶ A claim must satisfy both prongs of this test to be preempted.²⁷

¹² *Id.*

¹³ *Spear Mktg.*, 791 F.3d at 591.

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ *Id.* at 591, 600.

¹⁹ *Spear Mktg.*, 791 F.3d at 598.

²⁰ *Id.* at 591.

²¹ *Id.*

²² *Id.* at 592 (quoting *Louisiana v. Am. Nat. Prop. & Cas. Co.*, 746 F.3d 633, 636 (5th Cir. 2014)) ("Jurisdictional facts are determined at the time of removal and consequently post-removal events do not effect that properly established jurisdiction.").

²³ *Id.* at 593.

²⁴ *Id.*

²⁵ *Id.* at 597.

²⁶ *Id.* at 594.

²⁷ *Id.*

2016] SCOPE AND EFFECT OF COPYRIGHT ACT'S PREEMPTION OF STATE LAW 223

As to the first prong, the Fifth Circuit had previously held that the exclusivity of the federal copyright law, 17 U.S.C. § 301(a), completely preempts the substantive field but had not answered, until now, whether § 301(a) preemption extends to all works fixed in tangible media, including those excluded from copyright protection, such as ideas.²⁸ The parties disputed whether § 301(a) preemption extends to all works satisfying the requirements of § 102(a), even those that contain noncopyrightable material as defined in § 102(b).²⁹ SMI asserted that it carefully defined its trade secrets to only include ideas and concepts, thus excluding them from the subject matter of copyright.³⁰ Bancorp and ARGO argued that the preemption analysis should focus not on the copyrightability of the expression itself, but on the type of work—software.³¹ The Fifth Circuit determined that technical trade secrets found within VaultWorks fell within the subject matter of copyright.³² SMI based its case on the fact that ARGO stole its trade secrets by: (1) enticing SMI to perform a demo of its software to ARGO, as part of an acquisition pitch, and (2) receiving screenshots of VaultWorks from BCS during the implementation of CIO.³³ It was clear that these ideas appeared in a tangible medium—computer software.³⁴ Since the tangible medium falls within the subject matter of copyright as defined in § 102(a), so do the specific trade secrets contained within it.³⁵

Because most times, parties concede the subject-matter element, many of the court's decisions rest on the second (“equivalency”) element of the preemption test.³⁶ According to the second part of the test, the court examines SMI's causes of action to determine whether the causes of action protect rights equivalent to any of the exclusive rights of a federal copyright.³⁷ The district court held that SMI's conversion and theft claims were completely preempted, and the Fifth Circuit agreed.³⁸ SMI's conversion claim, to the extent it alleges conversion of intangible “confidential information” and “certain trade secrets,” was preempted.³⁹ In addition, copying, communicating, and transmitting are equivalent acts to reproducing and distributing. Thus, SMI's theft claim was also found to be validly preempted.⁴⁰ The court concluded this part of its analysis by affirming the district court's refusal to remand the case to the state court, holding the district court had jurisdiction under the Copyright Act's preemption provision.⁴¹

²⁸ *Id.* at 595.

²⁹ *Id.* at 594; 17 U.S.C. § 102 (2015).

³⁰ *Spear Mktg.*, 791 F.3d at 594.

³¹ *Id.*

³² *Id.* at 597.

³³ *Id.*

³⁴ *Id.*

³⁵ *Spear Mktg.*, 791 F.3d at 597.

³⁶ *Id.* at 595.

³⁷ *Id.* at 597.

³⁸ *Id.*

³⁹ *Id.* at 598.

⁴⁰ *Spear Mktg.*, 791 F.3d at 598.

⁴¹ *Id.*

SUMMARY JUDGMENT

a. Misappropriation of Trade Secrets

In order to establish trade secret misappropriation in Texas, the plaintiff must establish: (1) a trade secret existed; (2) the trade secret was acquired through a breach of a confidential relationship or discovered by improper means; and (3) use of the trade secret without authorization by the plaintiff.⁴² In their motion for summary judgment, defendants challenged the first and third elements of the test.⁴³ Defendants argued that the trade secrets were not substantially secret and that they did not “use” SMI’s purported trade secrets in developing their software.⁴⁴ The Court found that SMI failed to point to any genuine dispute regarding its misappropriation claim.⁴⁵

First, SMI argued that it produced sufficient evidence to prove that Bancorp shared SMI’s trade secrets with ARGO in order to help ARGO finalize the development of their software program.⁴⁶ Ultimately, the Court found that SMI produced evidence relevant to the second element of its misappropriation claim, but not to the third.⁴⁷ SMI produced nothing to prove that ARGO copied any design elements of VaultWorks, let alone that ARGO used SMI’s purported trade secrets in any manner.⁴⁸ There was no evidence of similarity between SMI’s software and the competing product.⁴⁹

Second, SMI contends, “that on multiple occasions, ARGO requested access to SMI’s trade secrets so that it could test and validate its own product but instead, Bancorp sent ARGO the trade secrets.”⁵⁰ But SMI’s record citations indicated that ARGO requested cash flow data from Bancorp so that it could adjust CIO to handle different cash flow situations. SMI cannot claim Bancorp’s branch cash flow data as its own trade secret.⁵¹ Moreover, SMI relied on *Cudd Pressure Control Inc. v. Roles*, which held that “an alleged misappropriator’s use of a trade secret ‘to validate’ its own product was enough to raise a genuine issue of material fact as to trade secret use.”⁵² In *Cudd*, a former employee showed Cudd Pressure Control’s confidential financial data to potential investors to secure financing for his own newly formed competing venture, in essence proving that such a business model was viable.⁵³ The Fifth Circuit found that this type of validation or “proof” was qualitatively different from the validation that allegedly occurred here—the use of Bancorp’s own records, as displayed in a

⁴² *Id.* at 600.

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ *Spear Mktg.*, 791 F.3d at 600.

⁴⁷ *Id.*

⁴⁸ *Id.* at 601.

⁴⁹ *Id.* at 601–02.

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² *Cudd Pressure Control Inc. v. Roles*, 328 F. App’x 961 (5th Cir. 2009) (unpublished).

⁵³ *Id.* at 966.

2016] SCOPE AND EFFECT OF COPYRIGHT ACT'S PREEMPTION OF STATE LAW 225

printout from VaultWorks, to test CIO's predictions with Bancorp's historical data.⁵⁴ SMI's reliance on *Cudd* was misplaced.⁵⁵

Finally, SMI argued a theory of trade secret use, based on timing.⁵⁶ According to SMI, "a jury could reasonably infer that [Defendants] used SMI's trade secrets" because ARGO, after years of unsuccessful attempts to license CIO to Bancorp, started making progress with Bancorp at about the same time that SMI attempted to sell VaultWorks to ARGO, and in the process, revealed trade secrets to ARGO.⁵⁷ However, SMI failed to identify how defendants allegedly used SMI's trade secrets, and cited no legal authority.⁵⁸ The mere fact that VaultWorks and CIO occupied the same market would not permit an inference of copying.⁵⁹ The Fifth Circuit affirmed the district court's dismissal of SMI's claims of misappropriation of trade secrets.⁶⁰

REMAINING CLAIMS

Additionally, the district court dismissed all of SMI's remaining claims.⁶¹ SMI waived merits consideration of its remaining eight claims by failing to identify any error in the district court's reasoning or submit any new authority in support of its position.⁶² The Fifth Circuit agreed with the district court.⁶³

HOLDINGS

In summary, SMI failed to provide sufficient evidence that its case should not be heard in federal court. The Fifth Circuit found that the district court properly considered only the original petition in deciding a software developer's motion to remand its state law claims. Further, the original petition provided a basis for federal jurisdiction where the state law claims were based on ideas in tangible media and such claims fell within the subject matter of copyright for purposes of 17 U.S.C. § 301(a). The district court's dismissal of the misappropriation of trade secrets claim was affirmed where there was no evidence of the similarity between SMI's software and the competing product.

⁵⁴ *Spear Mktg.*, 791 F.3d at 601.

⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ *Id.*

⁵⁸ *Id.*

⁵⁹ *Id.* at 602.

⁶⁰ *Id.*

⁶¹ *Spear Mktg.*, 791 F.3d at 602.

⁶² *Id.* at 603.

⁶³ *Id.*

**FORUM SELECTION BYLAW—WHETHER A BOARD-ADOPTED
FORUM SELECTION BYLAW CHOOSING NORTH CAROLINA
COURTS AS THE FORUM SHOULD BE UPHELD BY THE COURT OF
CHANCERY OF DELAWARE**

By Harrison Tatum*

City of Providence v. First Citizens Bancshares, Inc., 99 A.3d 229 (Del. Ch. 2014).

SUMMARY

In *City of Providence v. First Citizens Bancshares, Inc.*, the defendant, First Citizens Bancshares, a Delaware corporation (“FC North”), is a bank holding company headquartered in North Carolina that proposed to acquire by merger a bank holding company based in South Carolina, First Citizens Bancorporation, Inc., a South Carolina corporation (“FC South”).¹ On the same day as the proposed merger was announced, the board of directors of FC North (the “Board”) made various revisions to the corporate bylaws, one of which was the addition of a forum selection bylaw (the “Forum Selection Bylaw”).² In FC North’s corporate charter, the Board was given the power to make, adopt, or change the bylaws.³ After the revisions, the new bylaw designated as the forum for intra-corporate disputes “the United States District Court for the Eastern District of North Carolina, or, if that court lacks jurisdiction, any North Carolina state court with jurisdictionFalse”⁴ The Forum Selection Bylaw is identical to the one found facially valid in *Boilermakers Local 154 Retirement Fund v. Chevron Corporation* (“*Chevron*”), except that the Forum Selection Bylaw designates a court other than the state or federal courts of Delaware.⁵

The plaintiff, City of Providence (“Providence”), is a minority shareholder of FC North.⁶ Providence’s first complaint (the “Bylaw Complaint”) challenges the facial validity of the Forum Selection Bylaw and asserts breach of fiduciary duty for its adoption.⁷ The second complaint (the “Merger Complaint”) is against FC North’s board of directors in connection with the merger.⁸ In the Bylaw Complaint, Providence claims that the Forum Selection Bylaw is invalid under Delaware law and public policy (Count I) and seeks a declaratory judgment.⁹ In the alternative of a declaratory judgment, Providence claims that the court can exercise jurisdiction over any claim related to the merger (Count III).¹⁰ Providence further claims that the adoption of the Forum Selection Bylaw was “*ultra vires* and a breach of fiduciary duty”

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¹ *City of Providence v. First Citizens Bancshares, Inc.* 99 A.3d 229, 231 (Del.Ch. 2014).

² *Id.* at 231.

³ *Id.* at 233.

⁴ *Id.* at 230.

⁵ *Id.*

⁶ *Id.*

⁷ *Id.* at 232.

⁸ *Id.*

⁹ *Id.*

¹⁰ *Id.*

(Count II).¹¹ The Merger Complaint essentially claims that the majority shareholders forced FC North to overpay for FC South in order to gain an advantage by diluting the minority shareholders interest.¹²

Following Providence's complaints, the defendants filed a 12(b)(6) motion for failure to state a claim.¹³ In regards to Count II and the Merger Complaint, the defendants filed a 12(b)(3) motion for improper venue since the Forum Selection Bylaw designated North Carolina as the proper venue.¹⁴

ANALYSIS

The Court of Chancery of Delaware begins by analyzing Count I of the Bylaw Complaint. The court's analysis is guided by its previous analysis of Delaware law in *Boilermakers Local 154 Retirement Fund v. Chevron Corp.* ("*Chevron*").¹⁵ Under *Chevron*, the fact that FC North's charter grants the board the power to amend the bylaws puts the shareholders "on notice that as to those subjects that are subject of regulation by bylaw under 8 Del. C. § 109(b), the board itself may act unilaterally to adopt bylaws addressing subjects."¹⁶ In *Chevron*, the court found that the forum selection bylaws addressed the subject of the shareholders' "rights" under 8 Del. C. § 109(b).¹⁷ The court in *Chevron* concluded that the "rights" of the shareholders were addressed because forum selection bylaws regulate where a shareholder can exercise their right to bring claims against a corporation or its directors and officers.¹⁸ The court in *Chevron* further stated that bylaws are part of a binding contract between Delaware corporations and its shareholders, and that under this contractual framework the shareholders "assent to not having to assent to board-adopted bylaws."¹⁹

The court in the present case did note that the distinction between the Forum Selection Bylaw and the bylaw in *Chevron* initially created an issue since the bylaw in *Chevron* selected Delaware as the forum but the Forum Selection Bylaw designated North Carolina as the forum.²⁰ However, the court declared that this distinction does not call into question the facial validity of the Forum Selection Bylaw because nothing in *Chevron* prohibits a Delaware corporation from designating an exclusive forum outside of Delaware.²¹ Further, the court points out that North Carolina is the second most reasonable forum since most of FC North's operations and its headquarters are there.²²

¹¹ *Id.*

¹² *Id.*

¹³ *Id.*

¹⁴ *Id.*

¹⁵ *Boilermakers Local 154 Retirement Fund v. Chevron Corp.*, 73 A.3d 934 (Del.Ch. 2013).

¹⁶ *City of Providence*, 99 A.3d at 234 (citing *Chevron*, 73 A.3d at 935–36).

¹⁷ *Id.* at 234 (citing *Chevron*, 73 A.3d at 950–51).

¹⁸ *Id.*

¹⁹ *Id.* at 235 (citing *Chevron*, 73 A.3d at 955–56).

²⁰ *City of Providence*, 99 A.3d at 234.

²¹ *Id.* at 235.

²² *Id.*

In regards to Count III, the court stated that it did not need to analyze the substantive right or exclusive jurisdiction arguments because the arguments are “purely hypothetical” since Providence did not assert a claim in its complaints under any of the statutes addressed in its argument.²³ Moreover, the claims in the Merger Complaint are all Delaware common law claims and have previously been asserted in forums outside of Delaware such as North Carolina.²⁴

Count II of the Bylaw Complaint claims that the adoption of the Forum Selection Bylaw was a breach of fiduciary duty.²⁵ Specifically, in Count II, Providence claims: (i) the Forum Selection Bylaw “was motivated by a desire to protect the interests of the individual members of the Board and other affiliates of the Holding Group, including officers of the Company”; and (ii) the Board adopted the Forum Selection Bylaw “to insulate itself from the jurisdiction of Delaware courts.”²⁶ The court states that these claims are wholly conclusory since they provide no basis to infer that the Forum Selection Bylaw was a product of a breach of fiduciary duty.²⁷ Further, the Forum Selection Bylaw does not insulate the defendants from judicial review; “[i]t simply requires that such review take place in a court based in North Carolina.”²⁸ Providence fails to provide the court with any reason to question the integrity of the state and federal courts of North Carolina, nor do they provide any basis for the court to conclude that the defendants are advancing their self-interests by designating North Carolina instead of Delaware as the exclusive forum.²⁹

Lastly, the court turns its attention to whether the Forum Selection Bylaw is valid as applied which would dismiss the Merger Complaint for improper venue. Providence brings forth three “as applied” arguments to support its position that the Forum Selection Bylaw is invalid as applied.³⁰ First, Providence claims that “Delaware has an over-riding interest in resolving ‘novel and substantial’ issues raised in the Merger Complaint.”³¹ The court declared that “Delaware does not have an overarching public policy that prevents the stockholders of Delaware corporations from agreeing to exclusive foreign jurisdiction of any matter involving the internal affairs of such entities.”³²

Second Providence argues that the simultaneous adoption of the Forum Selection Bylaw and the merger agreement make the enforcement of the Forum Selection Bylaw unreasonable, unjust, and/or inequitable.³³ The court rejects this argument, citing to the explanation in *Chevron* “that an essential part of the contract shareholders [like Providence] assent to when they buy stock [in FC North] is one that presupposes the board’s authority to adopt binding

²³ *Id.* at 236.

²⁴ *Id.*

²⁵ *Id.* 236–37.

²⁶ *Id.* at 237.

²⁷ *Id.*

²⁸ *Id.*

²⁹ *Id.*

³⁰ *Id.* at 238.

³¹ *Id.*

³² *Id.* at 239–40 (citing *Baker v. Impact Hldg., Inc.*, 2010 WL 1931032, at *2 (Del.Ch. May 13, 2010)).

³³ *City of Providence*, 99 A.3d at 238.

bylaws consistent with 8 *Del. C.* § 109.³⁴ Further, the Court states that given the lack of any well-pled allegations in either of Providence's complaints it is immaterial that the bylaw was adopted on a "cloudy" day when it entered into the merger agreement rather than a "clear" day.³⁵

The Court disagrees with Providence's third "as applied" argument that the Forum Selection Bylaw is unjust because the Holding Group's control of the company prevents FC North's shareholders from repealing it.³⁶ The Court states that enforcement of a board-adopted forum selection bylaw is not unreasonable just because a controlling shareholder favors the adoption.³⁷ If the Court were to agree with Providence's argument it would put into question all board-adopted bylaws of controlled corporations.³⁸

³⁴ *Id.* at 240 (citing *Chevron*, 73 A.3d at 940).

³⁵ *City of Providence*, 99 A.3d at 241.

³⁶ *Id.*

³⁷ *Id.*

³⁸ *Id.*