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TEXAS JOURNAL OF BUSINESS LAW

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THE SOUND OF INEVITABILITY: THE DOCTRINE OF INEVITABLE DISCLOSURE OF TRADE SECRETS COMES TO TEXAS

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Agent Smith: You hear that Mr. Anderson? . . . That is the sound of inevitability . . . It is the sound of your death . . . Goodbye, Mr. Anderson. [1]

I. INTRODUCTION

It happens all the time. A promising new employee joins a company, eager to begin and do well. The company, in its own procedural excitement, gets right down to business by incorporating the new employee into the workplace and fails to secure an agreement from the employee not to compete with the company and not to disclose sensitive information. The company trains the employee on its own unique procedures, teaches him the tricks of the trade, and shares sensitive client and product information. Eventually, the employee leaves. Without a confidentiality agreement or covenant-not-to-compete, the question becomes to what extent are the employer's rights and information protected when compared to the employee's right to seek employment involving the skills he has acquired? Enter the Doctrine of Inevitable Disclosure.

Trade secret law exists only as state law.[2] In Texas, regardless of whether the employee is bound by contractual prohibitions not to disclose trade secrets, he is prohibited from doing so by the common law and the Texas Penal Code.[3] Most suits concerning Theft of Trade Secrets involve a former employer seeking injunctive relief to prohibit the use or disclosure of the trade secret.[4] At the same time, with economic globalization and information and employees becoming increasingly mobile, trade secret law and remedies available to employers are more imperative.[5] Where the employer fails to obtain a covenant-not-to-compete or confidentiality agreement from their employees, the employer has often been left without a remedy. Because Texas trade secret law does not provide the sort of broad protection many companies desire for sensitive and/or proprietary information, employers have begun to look for other legal options. It is out of this void that the Doctrine of Inevitable Disclosure (hereinafter the "Doctrine") has arisen in a growing number of jurisdictions. While the Doctrine has been alluded to in several Texas state and federal court cases, it is still unclear whether the majority of Texas courts are prepared to embrace it.

Protected trade secrets can range from technical knowledge, formulas or ingredients, to strategic decision-making such as pricing, marketing strategies, product development and budget information.[6] Traditionally, the courts have intervened on behalf of the employer in the

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[1] THE MATRIX (Warner Brothers 1999).

[2] Eleanore R. Godfrey, *Inevitable Disclosure of Trade Secrets: Employee Mobility v. Employer's Rights*, 3 J. High Tech. L. 161 (2004).

[3] TEX. PENAL CODE ANN. § 31.05 (Vernon 2003).

[4] Godfrey, *supra* note 2, at 161.

[5] *See id.*

[6] "[A] trade secret is 'any formula, pattern, device or compilation of information which is used in one's business and presents an opportunity to obtain an advantage over competitors who do not know or use it.'" *In re* Bass, 113 S.W.3d 735, 739 (Tex. 2003) (quoting Computer Assocs. Int'l, Inc. v. Altai, Inc., 918 S.W.2d 453, 455 (Tex. 1996)). "[C]ustomer lists, pricing information, client information, customer preferences, buyer contacts, market strategies, blueprints, and drawings have been shown to be trade secrets." T-N-T Motorsports v. Hennessey Motorsports, 965 S.W.2d 18, 22 (Tex. App.—Houston [1st Dist.] 1998, pet dism'd) (quoting Miller Paper Co. v. Roberts Paper Co., 901

face of actual or threatened misappropriation of trade secrets.[7] However, the Doctrine extends traditional trade secret misappropriation principles to cases where there is no evidence of actual, or even threatened, misappropriation or harm. "Employees who move between [competing] companies that use trade secrets are at the center of the inevitable conflict between the right of an employee to choose his or her employment and the right of an employer to protect its trade secrets."[8] Courts applying the Doctrine "can prevent the misappropriation of trade secrets based on the assumption that an employee in a given situation will *inevitably* use or *disclose* those secrets."[9] A potentially invaluable tool in protecting a company's intellectual capital, the Doctrine can also be fatal to the employee's right to mobility within a given industry. It is no doubt this tension has prevented the Doctrine from being adopted more readily.

II. HISTORY OF THE DOCTRINE

While there is some disagreement over exactly when the Doctrine first appeared in American jurisprudence,[10] it is clear that the Doctrine was being applied during the first quarter of the 20th century in response to employee mobility.[11] In 1902, the Seventh Circuit upheld an injunction against a former employee in *Harrison v. Glucose Sugar Refining Co.,* preventing him from disclosing secrets acquired during his employment.[12] The court in that case noted that it would be impossible, on a practical level, for a former employee to refrain from disclosing confidential information upon new employment with a competitor.[13]

In 1919, a New York state court exercised the principles of the Doctrine in *Eastman Kodak Co. v. Power Film Products, Inc.*[14] In this case, too, the employer, Eastman Kodak, brought an action for an injunction to prevent a former employee from disclosing secrets to a competitor at which he had become employed. Despite a lack of actual misappropriation, the

S.W.2d 593, 601 (Tex. App.—Amarillo 1995, no writ). "'Secret' implies that the information is not generally known or readily available." *T-N-T Motorsports*, 965 S.W.2d at 22 (quoting Rugen v. Interactive Bus. Sys. 846 S.W.2d 548, 552 (Tex. App.—Dallas 1993, no pet.). However, the mere fact that knowledge of a product or process may be acquired through inspection, experimentation, and analysis does not preclude protection from those who would secure that knowledge by unfair means. K & G Oil Tool & Serv. Co. v. G & G Fishing Tool Serv., 314 S.W.2d 782, 788 (Tex. 1958).

7 The Texas Supreme Court adopted the Restatement (Third) of Unfair Competition §39 test to determine whether a trade secret exists. In re Bass, 113 S.W.3d 735, 739 (Tex. 2003). Six factors are relevant in determining the existence of a trade secret: "(1) the extent to which the information is known outside of his business; (2) the extent to which it is known by employees and others involved in his business; (3) the extent of the measures taken by him to guard the secrecy of the information; (4) the value of the information to him and his competitors; (5) the amount of effort or money expended by him in developing the information; (6) the ease or difficulty with which the information could be properly acquired or duplicated by others." *Id.* The test is a non-exclusive balancing test; all six factors need not be satisfied to prove the existence of a trade secret. *Id.* at 740.

8 Paul C. Goulet, *The Doctrine of Inevitable Disclosure*, January, 2004, *available at* http://www.finnegan.com/publications/news-popup.cfm?id=1566&type=article, last visited 12/13/2007.

9 *Id.*

10 *See* Godfrey, *supra* note 3, at 168; *see also* Ted Lee and Leila Ben Debba, *Backdoor Non-Competes in Texas: Trade Secrets*, 36 St. Mary's L.J. 483, 520 (2005).

11 Lee and Ben Debba, *supra* note 10, at 520.

12 *Id.* (citing Harrison v. Glucose Sugar Refining Co., 116 F.304, at 312 (7th Cir. 1902)).

13 *Id.*

14 Eastman Kodak Co. v. Powers Film Prods., Inc., 179 N.Y.S. 325, 330 (1919).

court upheld non-compete and confidentiality agreements previously signed by the employee, holding that because the employee would necessarily impart knowledge in the rendition of service to his new employer, an injunction against imparting such special knowledge alone would be ineffective.[15] Notably, the court's analysis rested not on the existence of the non-compete and confidentiality agreements but on the inevitable failure of the employee to keep information confidential while employed by a direct competitor of his former employer.

The actual use of the phrase "inevitable disclosure" first occurred in *E.I. duPont de Nemours & Co. v. American Potash & Chemical Corporation* in 1964, roughly sixty years after the appearance of the Doctrine.[16] In this case, Hirsch, a former employee of duPont, began working for American Potash, at which point, duPont filed for a restraining order to prevent Hirsh from both disclosing duPont's trade secrets and working for Potash.[17] The trial court entered a preliminary injunction for duPont, despite the lack of a non-compete agreement.[18] The court of chancery, recognizing that the law "tends to encourage . . . substantial expenditures to find or improve ways and means of accomplishing commercial and industrial goals,"[19] upheld the injunction, holding that the degree of probability of disclosure, whether amounting to an inevitability or not, is properly considerable in determining whether a threat of misappropriation exists.[20]

Interestingly, the cases out of which the Doctrine arose are virtually identical to modern day cases and often address the same questions of equity and fairness. It is no surprise then that the use of the Doctrine and its underlying principles are just as pertinent today as when it was first applied over a century ago. It is from this history that the Doctrine has been revitalized and brought forward to the present for new debate and discussion of the right of the employer in protecting and encouraging investment in new technologies, processes, and ideas versus the right of the employee to seek new employment within his trade and the interest of the public in competition.

III. RESURRECTION OF THE DOCTRINE

The Doctrine is based on the notion that no matter how good an employee's intentions, it is impossible for him to compartmentalize the knowledge or experience gained from prior employment. Thus, it is unavoidable that the employee will disclose that information if he is required to do the same or similar work for a new employer. Although the Doctrine is not new to American or Texas Jurisprudence, the Doctrine's recent growth can be traced back to the landmark Seventh Circuit decision in *PepsiCo v. Redmond*.[21] *Redmond* is widely regarded for its contemporary formulation of the Doctrine largely because the decision sparked courts to apply the Doctrine with more frequency and vigor than any previous case applying the Doc-

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15 *Id.* at 330.

16 Godfrey, *supra* note 3, at 169.

17 *Id.* at 169-70 (citing E. I. duPont de Nemours & Co. v. American Potash & Chemical Corp., 200 A.2d 428 (Del. Ch. 1964)).

18 E. I. duPont de Nemours & Co. v. American Potash & Chemical Corp., 200 A.2d 428, 429 (Del. Ch. 1964).

19 *Id.* at 437.

20 *Id.* at 436.

21 *See generally,* Pepsi Co. v. Redmond, 54 F.3d 1262 (7th Cir. 1995).

trine.[22] *Redmond* is celebrated for three main reasons: (1) it analyzed inevitable disclosure under the Uniform Trade Secrets Act (hereinafter "UTSA") rather than under common law, (2) it applied the Doctrine to a non-technical employee working in a non-technical field, and, (3) it established a standard for whether the inevitable disclosure existed.[23]

A. Uniform Trade Secrets Act

The UTSA was approved by the National Conference of Commissioners on Uniform State Laws in 1979, the same year the Restatement 2nd of Torts was published without mention of trade secrets or trade secret protection. Unlike the first Restatement, published in 1939, the reporters deliberately left out a discussion of trade secret law because the body of law had grown, and, they believed, would continue to grow to such a degree that it would likely become its own subject matter area of law, perhaps one day requiring its own restatement.[24]

The purpose of the UTSA is to clarify definitions, codify case law, and establish statutes of limitation. Whereas the UTSA provides that "actual *or threatened"* misappropriation may be enjoined."[25] Most courts applying the Doctrine require a former employer to show at least that: (1) "trade secrets exist", (2) "the employee had access to them", and (3) "the trade secrets would inevitably be used."[26]

Despite the UTSA's apparent adoption of the Doctrine by providing for an injunction in the absence of *actual* misappropriation, it is of practically no use to Texas practitioners because Texas is one of only five states that have yet to adopt the UTSA.[27] Moreover, to be entitled to injunctive relief, Texas courts have consistently required proof of actual harm. Nonetheless, an understanding of *PepsiCo v. Redmond*[28] is essential to a comprehension of the Doctrine and how it operates in both UTSA and non-UTSA jurisdictions.

B. *Redmond v. PepsiCo*

Redmond, a high-level PepsiCo manager who had access to "inside information and trade secrets," went to work for Quaker Oats' "sports drink" and "new age drinks" division.[29] The District Court granted PepsiCo an injunction to prevent Redmond "from divulging . . . trade secrets and confidential information [acquired at PepsiCo] in his new job [at Quaker Oats] and from assuming any duties with Quaker relating to beverage pricing, marketing, and distribution."[30] At the week-long preliminary injunction hearing, PepsiCo presented evidence

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[22] Nathan Hamler, *The Impending Merger of the Inevitable Disclosure Doctrine and Negative Trade Secrets: Is Trade Secrets Law Headed in the Right Direction?*, 25 J. Corp. L. 383, 391 (2000).

[23] Brandy L. Treadway, *An Overview of Individual States' Application of Inevitable Disclosure: Concrete Doctrine of Equitable Tool?*, 55 SMU L. Rev. 621, 624 (2002).

[24] *See* Hamler, *supra* note 22, at 386.

[25] Unif. Trade Secrets Act §2(a) (1985) (emphasis added).

[26] *See* Gregory Porter and Joseph Beauchamp, *The Inevitable Disclosure Doctrine and Its Effect on Employee Mobility*, Houston Lawyer, 36, 37 (November/December, 2006).

[27] Unif. Trade Secrets Act (1985) (Table of Jurisdictions Wherein Act Has Been Adopted).

[28] *See Redmond*, 54 F.3d at 1262.

[29] *Id.* at 1264.

[30] *Id.* at 1263.

showing that Redmond was privy to its Strategic Plan, which contained PepsiCo's plans to compete, financial goals, and its strategies for manufacturing, production, marketing, packaging, and distribution for the next three years.[31] Redmond had also been entrusted by PepsiCo with knowledge of its Annual Operating Plan, which included much of the same information as the Strategic Plan but was limited in scope to the following year.[32] The District Court adopted PepsiCo's position in its entirety and found that Redmond's new job at Quaker Oats posed a clear threat of misappropriation that could be enjoined.[33]

The Seventh Circuit affirmed the District Court injunction.[34] In so doing, the court recognized that "[t]he question of threatened or inevitable misappropriation . . . lies at the heart of a basic tension in trade secret law."[35] Recognizing that this tension is especially heightened when an injunction is sought to prevent the mere threat that misappropriation will occur, the Seventh Circuit concluded that under the Illinois Trade Secret Act,[36] "a plaintiff may prove a claim of trade secret misappropriation by demonstrating that defendant's new employment will inevitably lead him to rely on the plaintiff's trade secrets."[37]

PepsiCo v. Redmond is of great importance for two reasons. First, it upheld an injunction preventing an employee from taking a position for a period of time, rather than enjoining merely the disclosure of trade secrets.[38] Second, it upheld an injunction where the former employee had not signed a covenant-not-to-compete.[39] It also expanded application of the Doctrine because it upheld an injunction outside the technical industry arena. Whereas the Doctrine historically only applied to prevent skilled employees in technical industries from taking jobs where they would inevitably disclose a former employee's trade secrets, *Redmond* expanded that concern to cover situations in which technical processes were not at issue, even though trade secrets were.[40] Although use of the Doctrine greatly increased after *Redmond*, disagreement continues regarding what elements must exist in order to apply the Doctrine.[41]

IV. TEXAS COURTS CONSIDER THE DOCTRINE

Despite the holding in *PepsiCo v. Redmond*, Texas continues to adhere to the Restatement 1st of Torts concept that a trade secret is not misappropriated until it is actually used.[42] Texas jurisprudence, however, has been trending toward a "watered-down" version of the Doctrine and has on occasion relied on a variation of the Doctrine to grant injunctive re-

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[31] *Id.* at 1265.

[32] *Id.*

[33] *Id.* at 1267.

[34] Pepsi Co. v. Redmond, 54 F.3d 1262, 1263 (7th Cir. 1995).

[35] *Id.* at 1268.

[36] Ill. Comp. Stat. Ann. 765 ILCS 1065/2-3 (1988).

[37] *Redmond*, 54 F.3 at 1269.

[38] *Id.* at 1272.

[39] *See Redmond*, 54 F.3d at 1262.

[40] Treadway, *supra* note 23, at 625.

[41] Godfrey, *supra* note 3, at 173.

[42] Troy A Martin, Comment, *The Evolution of Trade Secret Law in Texas: Is It Time to Recognize the Doctrine of Inevitable Disclosure?*, 42 S. Tex. L. Rev. 1361, 1388 (2001).

lief.[43]

A. Stepping Stones

One case from the Texas Supreme Court can be said to have set the precedent for the application of the Doctrine in Texas: *Hyde Corp. v. Huffines.*[44] In *Huffines*, the Court stated that "whether or not there is a breach of contract, the rule stated in this section subjects the actor to liability if his disclosure or use of another's trade secret is a breach of the confidence reposed in him by the other in disclosing the secret to him."[45] In *Huffines*, the parties had entered into a license agreement providing for royalty payments to the appellee based upon the appellee's invention.[46] The Court's holding was significant for recognizing a legal obligation on behalf of the appellant not to breach his duty of confidence despite the failure of the contractual language between the parties to preclude appellant from using the confidential information after termination of the license agreement.[47] Thus, the Court focused not on the misappropriation of trade secrets after the fact but on the breach of the employee's duty to keep the secrets confidential in the first place.

Nonetheless, the Doctrine is a "relatively new and unsettled concept under Texas law."[48] As the Houston First Court of Appeals noted in a 2003 decision, "no Texas case expressly adopt[ed] the inevitable disclosure doctrine, and it is unclear to what extent Texas courts might adopt it or might view it as relieving an injunction applicant of showing irreparable injury."[49] This is particularly so because "the fundamental premise of the inevitable doctrine is at odds with Texas' longstanding standards for misappropriation of trade secrets cases", including the "time-honored element" of misappropriation claims: the actual use of proprietary information.[50]

Earlier decisions by the Dallas and Houston Courts of Appeals, however, appear to have adopted some form of a "probable disclosure" rule. In the 1993 case of *Rugen v. Interactive Bus. Systems*, the Dallas Court affirmed a temporary injunction barring the defendant from soliciting or doing business with the plaintiff's customers that were identified on a customer list contained in a sealed exhibit and incorporated by reference in the injunction.[51] The plaintiff in *Rugen* was a computer personnel staffing company who had employed defendant as an account manager.[52] The defendant resigned and started her own computer personnel staffing

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[43] Treadway, *supra* note 23, at 642.

[44] *See generally* Hyde Corp v. Huffines, 314 S.W.2d 763 (Tex. 1958).

[45] *Id.* at 769.

[46] *Id*. at 766.

[47] *Id.*

[48] Patrick J. Maher, Covenants/Trade Secrets: A Continuing Education, Labor and Employment Law Section Annual Meeting of the State Bar of Texas, 12, http://www.shannongracey.com/documents/COVENANTS-TRADE%20SECRETS-%20a%20Continuing%20Evolution.pdf.

[49] Cardinal Health Staffing Network, Inc. v. Bowen, 106 S.W.3d 230, 242 (Tex. App.—Houston [1st Dist.] 2003, no pet.); Maher, *supra* note 48, at 12.

[50] Maher, *supra* note 48, at 12; Martin, *supra* note 44, at 1376.

[51] *Rugen*, 864 S.W.2d at 553.

[52] *Id.* at 550.

company which competed directly with the plaintiff.[53] In upholding the temporary injunction, the court found that "the Defendant is in possession of [the plaintiff's] confidential information and is in a position to use it. Under these circumstances, it is probable that [the defendant] will use the information for her benefit and to the detriment of [the plaintiff]."[54]

The Houston First Court of Appeals addressed the issue in 1998 in *T-N-T Motorsports, Inc. v. Hennessey Motorsports, Inc*.[55] In *T-N-T*, the plaintiff designed and sold high performance engine upgrades for various makes of vehicles.[56] Two employees involved in the manufacturing, sales, and research and development for T-N-T quit and started their own competing engine upgrade company.[57] The employees advertised that their product was identical to their former employer's product and provided similar packages, tests, equipment, and warranties.[58] The defendants further acknowledged that they had already taken three of the plaintiff's former customers.[59] Based on this, the court concluded that the defendants "possess [T-N-T]'s confidential information and are in a position to use it to compete directly with [T-N-T]," despite absence of a non-compete or confidentiality agreement.[60] As a result, the court enjoined the defendants from disclosing or using the specific trade secrets of the plaintiff.

In each of these cases, the courts were confronted with similar sets of facts. A plaintiff had hired or contracted with the defendant. As a necessary part in being able to perform his obligations, the defendant gained access to sensitive information including methods, research, designs, and client lists, to name a few. Both Dallas and Houston Courts of Appeal skirted the irreparable injury requirement, with each case turning on proof of actual possession of the confidential information of the former employer. Despite the lack of a non-competition or confidentiality agreement, these courts found that the defendants should be enjoined because of the probability that they would use the trade secrets garnered from their previous employer. However, unlike the Doctrine applied in *Redmond* to extend traditional trade secret misappropriation principles to cases where there is no evidence of actual, or even threatened, misappropriation or harm, the Texas courts in *Rugen* and *T-N-T* found that the former employees had actual possession of trade secrets, were in direct competition with their former employers, and were in a position to use the confidential information against them.

B. A Version of Doctrine Advances

In *Maxxim Medical, Inc. v. Michelson*,[61] a federal court in the Southern District of Texas, articulated a set of factors considered by various courts around the country that have adopted the inevitable or probable disclosure rule. These included the following:

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[53] *Id.* at 550.

[54] *Id.* at 552.

[55] *See generally* T-N-T Motorsports v. Hennessey Motorsports, 965 S.W.2d 18 (Tex. App.—Houston [1st Dist.] 1998, pet dism'd).

[56] *Id.* at 20.

[57] *Id.*

[58] *Id.*

[59] *Id.* at 20-21.

[60] *T-N-T Motorsports v. Hennessey Motorsports*, 965 S.W.2d at 22.

[61] Maxxim Med., Inc. v. Michelson, 51 F. Supp. 2d 773, 786 (S.D. Tex. 1999).

(1) degree of competition between the former and present employers;

(2) similarity between job positions;

(3) lack of candor on the part of the departing employee as to his or her new job;

(4) specificity with which the former employer has clearly identified the trade secrets;

(5) degree of actual use of trade secrets that has already occurred;

(6) existence of nondisclosure and noncompetition agreements between the former employer and employee;

(7) new employer's policies against use of trade secrets; and

(8) ability to sanitize the new position by taking steps to preclude improper use of trade secrets.[62]

The defendant in *Maxxim Medical* was a California salesman working for a Texas corporation that provided sterile prepackaged medical utensils to doctors.[63] The defendant was also a supervisor over other salesmen in California, Nevada, Arizona, and Texas.[64] After negotiating employment with another company but before resigning, the defendant asked another employee to print out a large batch of customer information that subsequently disappeared before the employee could get the list to the defendant.[65] The defendant admitted taking the list but said that the documents were illegible and useless.[66] After he left, other employees discovered that defendant had deleted a considerable amount of confidential information from his hard drive.[67] The federal district court found that because California had a greater interest in the outcome of this suit, California law should apply.[68] Concerning the misappropriation of trade secrets claim, the Court predicted that California would adopt the inevitable disclosure doctrine,[69] albeit an incorrect prediction. The court, applying the above factors, found that an injunction was appropriate to bar the defendant from working for a competitor.[70]

The Dallas Court of Appeals, in an unpublished opinion, came even closer to adopting a version of the Doctrine in *Conley v. DSC Communications Corp.*[71] In *Conley*, the defendant worked for DSC selling digital loop carriers for 16 years before leaving to work for

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[62] *Id.*

[63] *Id.* at 777.

[64] *Id.*

[65] *Id.*

[66] *Id.* at 778.

[67] *Maxxim*, 51 F. Supp. 2d at 786.

[68] *Id.* at 781.

[69] *Id.* at 786.

[70] *Id.* at 788.

[71] Conley v. DSC Commc'n Corp., No. 05-98-01051-CV, 1999 WL 89955 at *3 (Tex. App.—Dallas, Feb. 24, 1999) (not designated for publication).

AFC, a competing manufacturer of the same carriers.[72] Prior to his resignation, the defendant led the team for DSC responding to a major Request for Proposal ("RFP") from Sprint.[73] When defendant Conley left DSC for AFC, Sprint had narrowed its choice of digital loop carrier vendors to a short list including both DSC and AFC.[74] The plaintiff sought to enjoin the defendant based on the doctrine of inevitable disclosure.[75] The trial court granted an injunction enjoining Conley from working in any capacity to sell, market or support digital loop carrier products or aiding anyone else to do so, including Sprint.[76] Denying that the Court had previously adopted the Doctrine of Inevitable Disclosure, the Court acknowledged it had previously held that "enjoining an employee from using an employer's confidential information is appropriate when it is *probable* that the former employee will use the confidential information for his benefit (or his new employer's benefit) or to the detriment of his former employer."[77]

Conley argued that the Court should adopt the following factors when determining whether to enjoin an employee:

(1) whether the departing employee engaged in misconduct;

(2) whether the new employer needed its competitors information due to its own lack of technology;

(3) the degree to which the positions in question were similar;

(4) the efforts of the new employer to protect the former employer's trade secrets, and

(5) the existence of a noncompetition agreement between the former employer and departing employee.[78]

In applying the probable disclosure of trade secrets concept, the Court refused to rigidly apply Defendant's checklist in determining whether a temporary injunction should be issued.[79] However, it held that evidence of three of these factors could be helpful in supporting a trial court's decision to issue a temporary injunction "to the extent the factors show whether the employee is in possession of confidential information of his former employer and whether he or his new employer is in a position to use this information to the employee's or the new employer's advantage or the former employer's disadvantage."[80] These factors were: (1) the existence of misconduct upon the part of the departing employee, (2) the new employer's apparent need for the trade secret information of its competitors because of its lack of compara-

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[72] *Id.* at 1.

[73] *Id.*

[74] *Id.*

[75] *Id.*

[76] *Id.*

[77] *Conley v. DSC Commc'n Corp.*, No. 05-98-01051-CV, 1999 WL 89955 at *4.

[78] *Id.*

[79] *Id.*

[80] *Id.*

ble technology, and (3) whether there is a significant degree of similarity between the employee's former and current positions.[81]

The existence of misconduct has been considered by several courts. The Dallas court in *Conley* determined that while evidence of misconduct would support the issuance of an injunction, the absence of such evidence does not preclude the trial court from entering an injunction.[82] The new employer's ability to use any trade secrets brought over by the employee is an important factor because it shows whether the employee is in a position to use confidential information.[83] Likewise, the degree of similarity between the current and former jobs is important because it too shows whether the employee is in a position to use confidential information.[84] The court ultimately upheld the injunction because "Conley was in a position to use DSC's confidential information for his or AFC's benefit or to DSC's detriment."[85]

In *Cardinal Health*,[86] the First District Court of Appeals in Houston declined to expressly adopt the Doctrine. The defendant in *Cardinal Health*, Bowen, had worked for PHR, a pharmacy staffing business.[87] When PHR was acquired by Cardinal Health, Bowen left to work for CompleteRx, a pharmacy management company that Bowen had worked with while in the employ of PHR.[88] Bowen left Cardinal Health roughly two months after the buyout.[89] Cardinal Health brought an appeal from the trial court's denial of a temporary injunction against Bowen and CompleteRx.[90] On appeal, Cardinal Health urged that it was not required to show irreparable injury to get the temporary injunction based on the Doctrine as discussed in *Rugen* and *Conley*.[91]

The appellate court acknowledged that there is no Texas case law expressly adopting the Doctrine, but noted that the Dallas Court of Appeals had adopted at least some version of the Doctrine.[92] Rather than reject the Doctrine, the court declined to expressly adopt the Doctrine based on a lack of evidence presented by Cardinal Health to grant an injunction even with use of the Doctrine.[93] Of particular importance is the court's express recognition and discussion of the Doctrine, even without deciding to adopt it.

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[81] *Id.* at 4-6.

[82] Conley v. DSC Commc'n Corp., No. 05-98-01051-CV, 1999 WL 89955 at *3.

[83] *Id.*

[84] *Id.*

[85] *Id.* at 8.

[86] *Cardinal Health*, 106 S.W.3d at 242.

[87] *Id.* at 233.

[88] *Id.*

[89] *Id.*

[90] *Id.* at 234.

[91] *Id.* at 241.

[92] *Cardinal Health*, 106 S.W.3d at 242.

[93] *Id.*

V. OBSTACLES TO ADOPTION OF THE DOCTRINE IN TEXAS

The struggle between an employee's right to change jobs and an employer's right to protect its trade secrets is at the heart of the debate over acceptance of the Doctrine. Refusal to use the Doctrine could invite the loss of valuable trade secrets and, thus, discourage certain research and development.[94] Likewise, "the right to work does not translate into the right to steal."[95] On the other hand, Texas continues to stand by the U.S. Supreme Court adage that a state should not prevent a person from practicing his chosen occupation in an arbitrary way.[96] This is true both in Texas' treatment of the Doctrine and longstanding view of covenants-not-to-compete. Even though Texas courts have yet to adopt the Doctrine, there is a clear move toward its acceptance or, at least, toward acceptance of the Doctrine's underpinnings.

VI. INEVITABLE VERSUS PROBABLE DISCLOSURE

The Texas cases that have accepted the Doctrine as a basis for enjoining employment by a former employee at a competitor have not adopted the Doctrine outright. In *Rugen*, *infra*, the Dallas court stated that where the defendant is in possession of another's confidential information and in a position to use it, it is probable that information will be used for to the defendant's benefit and the plaintiff's detriment.[97] The hesitancy of Texas courts to issue a definitive position on whether to apply the "probable disclosure" standard or the "inevitable disclosure" standard, assuming that there is a difference between the two, has led to confusion and, arguably, a more conservative standard for use of the Doctrine in granting injunctions.

"Inevitable disclosure" occurs when a defendant has confidential information and will not be able to avoid using that knowledge to unfairly compete against the plaintiff.[98] While a thing that is "inevitable" is incapable of being avoided or evaded,[99] a thing that is "probable," is only supported by evidence strong enough to establish a presumption, but is not proved.[100] The difference between these two standards, while seemingly negligible, is significant when used to determine whether or not an injunction should issue.

A doctrine of inevitable disclosure would require a showing that the circumstances of the case are such that there is no possible way that the defendant could work for his or her new employer without disclosing trade secrets or information acquired from his or her previous employer. A doctrine of probable disclosure, by comparison, appears to be a lesser standard, requiring proof only that that it is probable, or proof enough to establish a presumption, that the employee will disclose information. Without direction from the appellate courts, practitioners and trial courts have been left in the dark with little more than a match to light their way in trying to determine whether an injunction will be issued to prevent the improper disclosure of sensitive, valuable trade secrets.

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94 *See* Porter, *supra* note 26, at 37.

95 Martin, *supra* note 45, at 1381.

96 Lee and Ben Debba, *supra* note 10, at 522.

97 *Rugen*, 864 S.W.2d at 552.

98 Black's Law Dictionary (8th ed. 2004).

99 Merriam-Webster's Online Dictionary, *available at* www.merriam-webster.com/dictionary/Inevitable.

100 Merriam-Webster's Online Dictionary, *available at* www.merriam-webster.com/dictionary/Probable.

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VII. REQUIREMENT OF ACTUAL HARM

One aspect of the Doctrine that must be reconciled with Texas law is the requirement of actual, imminent, and irreparable harm in order to obtain injunctive relief. Because equitable relief is available under the Doctrine without the proof of actual harm to the former Employer, this could explain why Texas courts have been hesitant to expressly adopt the Doctrine.

Under Texas law, the injury underlying a claim for injunctive relief must be actual and substantial or a real affirmative prospect of an actual and substantial injury.[101] An injunction should not issue when the evidence shows that at most, plaintiff will suffer inconvenience.[102] Nor may an injunction be issued to prevent merely speculative harm.[103]

A. Comparison of Texas Non-Compete Law and The Doctrine

Perhaps the closest analogy to the Doctrine in Texas is the Non-Compete statute. Indeed, the concepts of unlawful competition and the presumed unlawful disclosure of trade secrets (under the Doctrine) seem to be inextricably linked by courts that have recognized the Doctrine. This is for good reason. The presumption that a former key employee will invariably disclose company secrets does not apply if the employee goes to work for a non-competitor. No actual harm can be done. Conversely, when a key employee who has had access to a company's trade secret information leaves to work for a direct competitor, these courts have effectively created an implied covenant-not-to-compete.

The biggest distinction between the concepts of a covenant-not-to-compete and the Doctrine is in their enforcement. The Doctrine, on the one hand, is based upon case law. In the jurisdictions where it is recognized, proof of actual harm is not required, but instead harm is presumed. On the other hand, for a non-compete agreement to be enforceable in the State of Texas, it must be express and comply with the statutory requirements. Injunctive relief cannot be had without proof of actual harm.

Generally, in order for the breach of such a covenant to occur, the Employee must also undertake a more active participation in the competing enterprise, such as giving the competitor the benefit of his experience, knowledge, and/or influence to assist the competitor in the conduct of his competing business, in addition to rendering financial assistance.[104]

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[101] Parkem Indus. Servs., Inc. v. Garton, 619 S.W.2d 428, 430 (Civ. App.—Amarillo 1981, no writ).

[102] Northcutt v. Waren, 326 S.W.2d 10, 10 (Civ. App.—Texarkana 1959, writ ref'd. n.r.e.).

[103] *See, e.g.,* Camarena v. Tex. Employment Comm'n, 754 S.W.2d 149, 151 (Tex. 1988) (at time of judgment, agency had not attempted to deny benefits of new legislation, so controversy before court was not ripe); Frey v. DeCordova Bend Estates Owners Ass'n, 647 S.W.2d 246, 248 (Tex. 1983) (no showing that association intended to assess fees); Benefield v. State *ex rel*. Alvin Cmty. Health Endeavor, Inc., 266 S.W.3d 25, 31 (Tex. App.—Houston [1st Dist.] 2008, no pet.) ("At most, Brazoria County has established a fear of the possibility of a future injury, and such a contingency 'is not sufficient to support issuance of a temporary injunction.'") (citing Reach Group, L.L.C. v. Angelina Group*,* 173 S.W.3d 834, 838 (Tex. App.—Houston [14th Dist.] 2005, no pet.)) (quoting EMSL Analytical, Inc. v. Younker, 154 S.W.3d 693, 697 (Tex. App.—Houston [14th Dist.] 2004, no pet.)).

[104] *See* Annotation, *Rendering Financial or Other Assistance to Another as Breach of Covenant not to Compete*, 1 A.L.R.3d 778, 785-86 (1965) (citing Pitts v. Ashcraft, 586 S.W.2d 685, 692 (Tex. Civ. App.—Corpus Christi 1979, writ refd n.r.e.).

However, engaging in actual competition is not actionable unless it results in real, measurable harm to the former employer. In *Prosperity Bank v. Rogge*, the bank sought to enforce a non-compete against a vice-president who investigated working elsewhere but was not hired by the competing entity. [105] The vice-president did not express any intention of breaching the agreement and had not been hired by competitor.[106] Because the former employer's suspicions were not supported by the evidence, Houston's First Court of Appeals held the bank suffered no irreparable harm and denied its request for injunctive relief holding that where "the record establishes 'only a fear of possible injury,' such a contingency 'is not sufficient to support issuance of a temporary injunction.'"[107]

Our sister court held that EMSL established only "a theoretical possibility that Younker could take Lockheed away as a customer" as well as "a theoretical possibility that Younker could divulge EMSL's confidential information to Lockheed or some other entity." [108] On the other hand, Younker's uncontroverted testimony refuted both of EMSL's theoretical reasons for needing a temporary injunction. [109] The court concluded that EMSL "failed to establish that it faced probable, imminent, and irreparable injury in the absence of a temporary injunction."[110]

B. The Doctrine and Texas Trade Secret Law

Likewise, Theft of Trade Secrets is not actionable in Texas if the threat is merely the possibility or likelihood that a former employee will use trade secret information at some point in the future to compete against his former employer. Texas jurisprudence requires that a party must show *actual damages* to prevail on a claim that a defendant tortuously interfered with its existing and prospective business relationships or misappropriated trade secrets.[111]

Recently, some Texas courts have applied a "use" standard as the basis for actual harm in dealing with the misappropriation of trade secrets.[112] Use (i.e., commercial use) generally occurs whenever there is "any exploitation of the trade secret that is likely to result in an

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[105] Prosperity Bank v. Rogge, No. 01-07-00161-CV, 2007 Tex. App. LEXIS 5505, *7-9 (Tex. App.—Houston [1st Dist.] 2007, no pet).

[106] *Id.* at *9.

[107] *Id.* at *15 (citing Reach Group, L.L.C. v. Angelina Group, 173 S.W.3d 834, 838 (Tex. App.--Houston [14th Dist.] 2005, no pet.)) (citing EMSL Analytical, Inc. v. Younker, 154 S.W.3d 693, 697 (Tex. App.—Houston [14th Dist.] 2004, no pet.).

[108] *EMSL*, 154 S.W.3d at 697.

[109] *Id.*

[110] *Id.* at 698 (citing Butnaru v. Ford Motor Co. 84 S.W.3d 198, 204 (Tex. 2002)). *Cardinal Health*, 106 S.W.3d at 242-43 (holding movant failed to demonstrate probable injury from violation of non-compete clause and possible violation of nondisclosure clause where former employee did not need to use former employer's confidential information in new job); *Benefield,* 266 S.W.3d at 31 (corporate dispute related to the appointment of a receiver; injunction rejected because no imminent harm shown, only the possibility of same.).

[111] *See* KTRK Television, Inc. v. Fowkes, 981 S.W.2d 779, 790 (Tex. App.—Houston [1st Dist.] 1998, pet. denied), *rev'd on other grounds*, 38 S.W.3d 103 (Tex. 2000); Trilogy Software, Inc. v. Callidus Software, Inc., 143 S.W.3d 452, 463 (Tex. App.—Austin 2004, pet. denied); Speedemissions, Inc. v. Capital C Enters., 2008 LEXIS 7303, *7-8 (Tex. App.—Houston [1st Dist.] Aug. 28, 2008, no pet.).

[112] Cudd Pressure Control Inc. v. Roles, 2009 U.S. App. LEXIS 12607 (5th Cir. June 11, 2009).

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injury to the trade secret owner or enrichment to the defendant." For an employee to have used a trade secret such that he would cause actual harm, he would need to misappropriate the secret, followed by an exercise of control and dominion over the information. An example of such use is found in *Cudd Pressure Control Inc. v. Roles*, where the 5th Circuit Court of Appeals ruled that an employee's use of his former employer's trade secret [a *Cudd* profit and loss statement to investors] in an effort to procure financing for the employee's new, competing company was sufficient "use" to cause actual harm whether by injuring the trade secret owner or enriching the competing company.[113]

However, the *Cudd* court found that the requirement of proof of damages actual harm under the Theft of Trade Secrets cause of action may be satisfied by a finding that the former employee is a fiduciary who breached his duty to his former employer not to disclose trade secrets after leaving the company. In applying the obligation of a fiduciary to the former employee, the 5th Circuit concluded that although "an employee may plan to go into competition with his employer, and such preparations will not constitute a breach of fiduciary duty…an employee 'may not appropriate his employer's trade secrets' or 'carry away certain information'".[114] In this sense, such an employee will be considered to have breached his fiduciary duty, injuring his former employer. Yet, the court noted, "one 'need not be damaged by a breach of fiduciary duty to be entitled to receive the benefits made from such a breach by the Defendants'" and the court cites to *Burrow v. Arce*, which states that:

> It is the agent's disloyalty, not any resulting harm, that violates the fiduciary relationship and thus impairs the basis for compensation. An agent's compensation is not only for specific results but also for loyalty. Removing the disincentive of forfeiture except when harm results would prompt an agent to attempt to calculate whether particular conduct, though disloyal to the principal, might nevertheless be harmless to the principal and profitable to the agent. The main purpose of forfeiture is not to compensate an injured principal, even though it may have that effect. Rather, the central purpose of the equitable remedy of forfeiture is to protect relationships of trust by discouraging agents' disloyalty.[115]

Thus, the 5th Circuit posits that actual "use" of the trade secret is not the only means by which an employee may injure his ex-employer. If the employee is properly a fiduciary, the mere carrying away of secret information is enough to cause injury, regardless of whether the trade secret is used to unfairly compete against his former employer.

The Restatement 3rd of Unfair Competition and Restatement 2nd of Contracts appear to provide the "innocent" employee who has been exposed to trade secrets but not used them with some protection against an absolute prohibition against working for a competitor in the future. Both Restatements make it clear that contractual restrictions on an employee's activities based upon exposure to trade secrets are only enforceable to the extent that such restrictions do not constitute an undue restraint on legitimate competition or trade and the re-

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[113] *Id.* at 13.

[114] *Id.* at HN 6.

[115] *Id.* at 13; Burrow v. Arce, 997 S.W.2d 229, 238 (Tex. 1999).

straint must be ancillary to the competition.[116] The Restatement 3rd of Unfair Competition follows the law in Texas that a court may not "enjoin employees who had knowledge of a former employer's trade secrets from engaging in a particular occupation or working for a particular competitor in the absence of…clear evidence that the contemplated employment will result in disclosure of the secret."[117] Further, in the interest of safeguarding the employee's rights, the employer must meet a balancing test; i.e., whether the information sought to be protected exceeds the hardship on the employee and the likely injury to the public. The restraint of an employee cannot go so far as to limit competition in any business or restrict him from gainful occupation and earning his livelihood. But, in a departure from Texas jurisprudence, the both Restatements also allow more leeway in favor of employees when it comes to the fiduciary duty owed to their former employer. Rather than impose a rule that mere exposure to trade secrets without actual use would subject employees to a breach of fiduciary duty claim, the Restatement 3rd of Unfair Competition states that former employees are "entitled to exploit their general skill, knowledge, training, and experience, even when acquired or enhanced through the resources of the former employer," and, such information that formed the skills and knowledge cannot be claimed as a trade secret or breach of fiduciary duty by a former employer.[118]

VIII. TOWARDS A COMPREHENSIVE APPROACH TO TRADE SECRET PROTECTION

As discussed above, there is considerable overlap in the law and the Restatements governing the Doctrine, non-compete clauses, and trade secrets. In dealing with trade secrets alone, the Restatement 3rd of Unfair Competition cites to the Uniform Trade Secrets Act, Restatement 2nd of Torts, Restatement 2nd of Agency, and Restatement 2nd of Contracts as having concurrent authority, thereby giving a plaintiff numerous causes of action and avenues of relief arising out of a single allegation of trade secret theft.

Perhaps, the primary reason that the various laws, model codes, and authorities have not been condensed into a single, uniform source is the risk that valid bases for relief would be eliminated. This reflects the difficulty in creating a single, all-encompassing body of law to account for all of the disparate circumstances and myriad of exceptions that exist when dealing with the concepts of unfair competition, trade secrets, non-compete agreements, contracts and torts. When specifically taking the Doctrine of Inevitable Disclosure into consideration, this point is even more pertinent. Many jurisdictions, such as Texas, have not expressly adopted the Doctrine. Still, others use the Doctrine only in relation to non-compete clauses and injunctive relief. Further, there is the dispute among some jurisdictions as to whether the Doctrine should apply to a general unwillingness to preserve confidentiality or only to actual misappropriation.[119]

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[116] RESTATEMENT (THIRD) OF UNFAIR COMPETITION § 44 (1995); RESTATEMENT (THIRD) OF UNFAIR COMPETITION § 186 (1995); RESTATEMENT (SECOND) OF CONTRACTS §188 (1981).

[117] RESTATEMENT (THIRD) OF UNFAIR COMPETITION § 44 (1995).

[118] RESTATEMENT (THIRD) OF UNFAIR COMPETITION § 42 (1995); RESTATEMENT (THIRD) OF UNFAIR COMPETITION § 41 (1995).

[119] *See* 36 A.L.R. 6th 537.

However, the argument that a comprehensive approach should be adopted for dealing with confidential and trade secret information is highly appropriate given that the cases frequently deal with multiple, overlapping, and, sometimes, disparate principles of law. As demonstrated throughout this section, the Doctrine and non-compete clauses constantly form the basis of plaintiffs' complaints, as do the Doctrine and trade secrets, or the Doctrine, trade secrets, and non-compete clauses simultaneously.[120] While it may be difficult (if not impossible) to subsume all three areas into one overarching doctrine, the Restatement of Unfair Competition has already begun the process of addressing trade secrets, non-compete clauses, fiduciary duties, and confidentiality rights in setting out its standards.

Although there is not a clear answer as to how each of these areas of law should be systematically approached with respect to the other, there is a growing trend to include these three areas together within specific divisions of law.

D. Jurisdictions Rejecting the Doctrine

Since this article was originally submitted, acceptance of the Doctrine in the United States has remained relatively static, though most states have adopted the USTA. Texas remains in the company of a handful of jurisdictions that have neither rejected the Doctrine nor adopted it outright. Among the states adopting a "lite" version of the Doctrine are Connecticut, Massachusetts, North Carolina, and New York.[121]

Several states, including both California and Florida, have directly rejected the Doctrine.[122] Florida courts have recognized the Doctrine under its common law history. But, more recently, Florida has called the applicability of the Doctrine into question.[123] In a federal case commenting on both California and Florida law, the Southern District of Florida held that the Doctrine applies only in the complete absence of a non-compete agreement.[124] Interestingly, though, the court discussed threatened misappropriation and inevitable disclosure as if they are two wholly separate theories, rather than viewing the Doctrine as a means of proving up threatened misappropriation.[125]

On the other hand, California "has a strong public policy favoring employee mobility and voids most non-compete agreements."[126] As a result, it is understandable that California courts have been reluctant to accept a doctrine that produces the same result as an enforceable covenant-not-to-compete.[127] Although California adopted the injunctive provision of the UTSA,[128] in 1999, it rejected the Doctrine ignoring previous California cases establishing fac-

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[120] *See* 7 Tul. J. Tech. & Intell. Prop. 167.

[121] *See* Treadway, *supra* note 23, at 621-22.

[122] *Id.* at 646, 648.

[123] *See* Brandy L. Treadway, *An Overview of Individual States' Application of Inevitable Disclosure: Concrete Doctrine of Equitable Tool?*, 55 SMU L. Rev. 621, 624 (2002).

[124] *Id.* at 647.

[125] *Id.* at 647-48.

[126] Brandy L. Treadway, *supra* note 123, at 621.

[127] *Id.*

[128] *Id.*

tors for the Doctrine.[129]

For those states that have adopted the USTA, it appears acceptance or rejection of the Doctrine has turned on the provision of the USTA that "actual or threatened misappropriation may be enjoined." Because the UTSA fails to define the term "threatened" misappropriation, there has been a divergence of opinion on how threatened misappropriation should be addressed. The extremes of this diverging opinion are represented by the States of California and New York.

The California View

In *Whyte v. Schlage Lock Co.*, the California Court of Appeals found that the inevitable disclosure doctrine is contrary to California law and policy because it creates an after-the-fact covenant-not-to-compete restricting employee mobility.[130] Citing the *PepsiCo* case and the California Business and Professional Code §16600, the Court said:

> The chief ill in the covenant not to compete imposed by the inevitable disclosure doctrine is its after-the-fact nature: The covenant is imposed after the employment contract is made and therefore alters the employment relationship without the employee's consent. When, as here, a confidentiality agreement is in place, the inevitable disclosure doctrine "in effect convert[s] the confidentiality agreement into such a covenant [not to compete]." PSC, Inc. v. Reiss, supra, 111 F.Supp.2d at p. 257. Or, as another federal court put it, "[a] court should not allow a plaintiff to use inevitable disclosure as an after-the-fact non-compete agreement to enjoin an employee from working for the employer of his or her choice." Del Monte Fresh Produce Co. v. Dole Food Co., Inc., supra, 148 F.Supp.2d at p. 1337; see also Matheson, Employee Beware: The Irreparable Damage of the Inevitable Disclosure Doctrine (1998) 10 Loyola Consumer L.Rev. 145, 162 ["the inevitable disclosure doctrine transforms employee access to trade secrets into a de facto non-competition agreement"].

The doctrine of inevitable disclosure thus rewrites the employment agreement and "such retroactive alterations distort the terms of the employment relationship and upset the balance which courts have attempted to achieve in construing non-compete agreements." *EarthWeb, Inc. v. Schlack*, *supra*, 71 F.Supp.2d at p. 311. The result, as the EarthWeb court explained, is "the imperceptible shift in bargaining power that necessarily occurs upon the commencement of an employment relationship marked by the execution of a confidentiality agreement. When that relationship eventually ends, the parties' confidentiality agreement may be wielded as a restrictive covenant, depending on how the employer views the new job its former employee has accepted. This can be a powerful weapon in the hands of an employer; the risk of litigation alone may have a chilling effect on the employee." Id. at p. 310. As a result of the inevitable disclosure doctrine, the employer obtains the benefit of a contractual provision it did not pay for, while the employee is bound by a court-imposed contract provision with no opportunity to negotiate terms or consideration. *Matheson*, *supra*, 10 Loyola Consumer L.Rev. at p. 160.

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[129] *Id.* at 645.

[130] Whyte v. Schlage Lock Co., 101 Cal.App.4th 1443, 1446 (2002).

> Lest there be any doubt about our holding, our rejection of the inevitable disclosure doctrine is complete. If a covenant not to compete (which would include, for example, a nonsolicitation clause), is part of the employment agreement, the inevitable disclosure doctrine cannot be invoked to supplement the covenant, alter its meaning, or make an otherwise unenforceable covenant enforceable. California law concerning enforcement of noncompetition agreements, not the inevitable disclosure doctrine, would measure the covenant's scope, meaning, and validity. Our opinion does not change that law. Under the circumstances presented in this case, an employer might prevent disclosure of trade secrets through, for example, an agreed-upon and reasonable nonsolicitation clause that is narrowly drafted for the purpose of protecting trade secrets. Thus, regardless whether a covenant not to compete is part of the employment agreement, the inevitable disclosure doctrine cannot be used as a substitute for proving actual or threatened misappropriation of trade secrets.[131]

More recently, however, the Fifth District Court of Appeal, in *Central Valley General Hospital v. Smith*, appeared to blur the distinction between "threatened" misappropriation and inevitable disclosure.[132] The defendant in that case argued that California's rejection of the inevitable disclosure doctrine effectively preempted a court's ability to enjoin conduct that "threatened" the disclosure of a trade secret. The Court disagreed, stating, "The principle that threatened misappropriation of trade secrets may be enjoined is the law of California despite the rejection of the inevitable disclosure doctrine by California courts."[133] The Court established four alternative fact criteria to consider when attempting to prove threatened misappropriation:

> (1) Proof that the former employer had protectable trade secrets, that those trade secrets remain in the knowledge of the former employee, and that the former employee has misused or disclosed some of those trade secrets in the past.[134] Evidence that a person has misappropriated trade secrets in the past is evidence sufficient to establish that that former employee may do it again;
>
> (2) Evidence that the former employee "intends to improperly use of disclose some of those trade secrets." This variant requires the moving party to establish the actual intent of the employee to misuse the trade secrets;
>
> (3) Proof that the former employee and new employer wrongfully refuse to return the trade secrets after a demand for their return has been made. The Court did not formally adopt this variant as an acceptable means of proving threatened misappropriation; rather, it merely assumed that such evidence might be sufficient to support an injunction; or

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131 *Id.* at 1462-64.

132 Central Valley General Hospital v. Smith, 162 Cal. App. 4th.501 (2008).

133 *Id.* at 525.

134 *Id.* at 527.

> (4) Whether threatened misappropriation could be established if the only factual showing is the defendant was in actual possession of the trade secrets. The Court expressly found that a claim of threatened misappropriation "requires a greater showing than mere possession by the defendant of trade secrets where the defendant acquired the trade secret by proper means."[135]

While California has refused to adopt the inevitable disclosure doctrine, the doctrine of "threatened misappropriation" remains a viable alternative to enjoin the misuse or the misappropriation of trade secrets before the harm actually occurs.

E. States Accepting the Doctrine

Among the states adopting the inevitable disclosure doctrine, perhaps none has embraced and expanded the scope of it as arduously as the State of New York.

The New York View

In recent years, New York courts have shown a willingness to grant preliminary injunctions even where the employer presents no evidence of actual or intended disclosure of trade secrets but merely evidence that the employee will "inevitably" disclose the trade secrets in his new employment. In this way, the Doctrine can fill an evidentiary void, allowing an employer to make a critical showing without providing specific evidence of actual misconduct.

Essential factors in this analysis include: (1) the extent to which the new employer is a direct competitor of the former employer; (2) the degree of similarity between the employee's former and new positions; and (3) the value of the purported trade secrets to the new and former employers.[136] Other case-specific factors such as the nature of the industry or the former employer's efforts to prevent the disclosure of trade secrets may be considered as well.

In *IBM v. Papermaster*, the United States District Court for the Southern District of New York seemed willing to expand the scope of the inevitable disclosure doctrine even beyond other jurisdictions that have adopted the doctrine.[137] Historically, courts that have adopted the inevitable disclosure doctrine have done so to resolve the "threatened" misappropriation prohibition under the USTA. However, in *IBM v. Papermaster*, the Court treated the Doctrine as a separate article of proof justifying the issuance of an injunction prohibiting a former employee from joining a competitor. In this case, the Court found that a former employee may be enjoined from joining a competitor "[e]ven where a trade secret has not yet been disclosed" ruling that "irreparable harm may be found based upon a finding the trade secrets will inevitably disclosed, where . . . the movant competes directly with the prospective employer and the transient employee possesses highly confidential or technical knowledge concerning marketing strategies or the like."[138]

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[135] *Id.* at 528.
[136] *See, e.g.* Earth Web, Inv. v. Schlack, 71 F.Supp.2d 299, 310 (S.D.N.Y. 1999).
[137] IBM v. Papermaster, No. 08-CV-9078, 2008 WL 4974508 (S.D.N.Y. Nov. 21, 2008).
[138] *Id.* at *7 (citing Estee Lauder v. Batra, 430 F.Supp.2d 158, 174 (S.D.N.Y. 2006).

The *IBM* court further found that "because [defendant] has been inculcated with some of IBM's most sensitive and closely-guarded technical and strategic secrets, it is no great leap for the Court to find that plaintiff has met its burden of showing a likelihood of irreparable harm."[139] The *IBM* Court cited two factors that make the likelihood of irreparable harm more than mere speculation: (1) the defendant acknowledged in his employment agreement that IBM would suffer "irreparable harm" if he violated the noncompetition agreement; and, (2) it is inconceivable that the defendant would not draw upon his IBM experiences in making marketing decisions on behalf of his new employer.[140]

In *International Business Machines Corp. v. Visentin*, the Court refused to find that a former senior executive would *not* inevitably use or disclose the former employer's trade secrets.[141] Although the Court recognized that the doctrine could be used as the basis for an injunction in the appropriate case, it refused to apply the Doctrine to the facts in *IBM* due to the evidence of the employee's loyalty and good faith. Because of these actions taken by the employee, the Court posited that there was little risk that his work for his new employer, HP, would threaten IBM.

V. MEASURES EMPLOYERS CAN TAKE

While it is true that the Doctrine's use requires the restriction of a person's rights without proof that he or she as actually disclosed trade secrets, once such trade secrets have been disclosed, the secrecy may be lost and the damage irreversible . Rather than having to resort to the imperfect world of litigation, a company is far better off taking preventative measures to help protect against the misappropriation of its trade secrets. The following are several suggestions to minimize companies' risk of losing its confidential, proprietary, and trade secret information.

First, employers should have all existing employees in key positions enter into a non-compete agreement. This is often done by offering access to special training and access to confidential, proprietary and trade secret information. This applies to both current and new employees, while no additional consideration is required for new employees as long as they enter into the non-compete agreement at the time of hire. Where an existing employee has already been given access to such information, other consideration will be required. Covenants-not-to-compete that comply with the statutory criteria are enforceable by Texas courts.[142] The determination of which non-compete agreements are enforceable is necessarily fact-specific.

As the focus of its fact inquiry, the courts have tended to look at whether the non-compete is supported by adequate consideration and whether the restrictions placed on the employee are reasonable. Compensation and benefits have not historically been considered true

[139] *Id.* at *8.

[140] *Id.* at *9.

[141] International Business Machines Corp. v. Visentin, No. 11 Civ. 399, 2011 WL 672025 (S.D.N.Y. Feb. 16, 2011).

[142] TEX. BUS. & COM. CODE ANN. §15.50 (Vernon 2007). (a) Notwithstanding Section 15.05 of this code, and subject to any applicable provision of Subsection (b), a covenant not to compete is enforceable if it is ancillary to or part of an otherwise enforceable agreement at the time the agreement is made to the extent that it contains limitations as to time, geographical area, and scope of activity to be restrained that are reasonable and do not impose a greater restraint than is necessary to protect the goodwill or other business interest of the promisee.

"consideration" for a Texas non-compete. Rather, the employer's need for the non-compete must be balanced by the promise to provide confidential data to the employee. Texas is somewhat unique in this regard. "Reasonableness" of the non-compete provision as a restraint upon trade is also of paramount importance. This requirement has been undergoing a steady evolution over the past several years.

In 2006, the Texas Supreme Court revisited the requirements of the non-compete statute with the case of *Alex Sheshunoff Mgmt. Servs., L.P. v. Johnson.*[143] The Court addressed concerns that have driven disputes over whether a covenant is ancillary to an otherwise enforceable agreement, such as the amount of information an employee has received, its importance, its true degree of confidentiality, and the time period over which it is received—should be addressed in determining (1) whether and (2) to what extent a restraint on competition is justified..[144] Thus, when the employer promised to disclose confidential information and to provide specialized training under an agreement and the employee promised not to disclose such confidential information, the covenant was ancillary to or part of agreement under these two requirements and enforceable, even for at-will employees.[145]

Under *Sheshunoff*, the consideration for the non-compete depended upon the *actual transfer* of trade secrets and confidential information from the Employer to the Employee. Merely placing an employee in a position to have *access to or develop* trade secrets or confidential information" is an illusory promise and cannot support a promise not-to-compete in return from an employee.[146] Therefore, in order for the breach of such a covenant to occur, the Employee must also undertake a more active participation in the competing enterprise, such as giving the competitor the benefit of his experience, knowledge, and/or influence to assist the competitor in the conduct of his competing business, in addition to rendering financial assistance.[147]

In 2009, the Texas Supreme Court in *Mann Frankfort Stein & Lipp Advisors, Inc. v. Fielding* significantly diluted the requirement of mutuality in a contract in order to protect the employer's confidential information.[148] Here, the Court concluded that a one-sided promise by an employee not to use or disclose his employer's confidential information under a "client purchase provision" in an at-will employment agreement was an enforceable covenant-not-to-compete because: (1) the employee expressly promised not to disclose confidential information; and, (2) the employer, *by implication*, promised to furnish the employee with confidential information.[149] Therefore, the parties exchanged *mutual* promises and the "client purchase provision was part of an "otherwise enforceable agreement" under the Texas Business

[143] Alex Sheshunoff Mgmt. Servs., L.P. v. Johnson, 209 S.W.3d 644, 655 (Tex. 2006).

[144] *Id.* at 655-56.

[145] *Id.* at 648-49.

[146] *Id.* at 647.

[147] *See* Annot., Rendering Financial or Other Assistance to Another as Breach of Covenant not to Compete, *1 A.L.R.3d 778*, §3(b), pp. 785-86 (1965); *see also* Pitts v. Ashcraft, 586 S.W.2d 685, 1979 Tex. App. LEXIS 4069 (Tex. Civ. App.-Corpus Christi 1979, writ refd n.r.e.).

[148] Mann Frankfort Stein & Lipp Advisors, Inc. v. Fielding, 289 S.W.3d 844, 855 (Tex. 2009).

[149] *Id.* at 852.

and Commerce Code.[150]

Last year, the Texas Supreme Court continued its progressive expansion of the employer's rights holding that a covenant-not- to-compete signed by a *current employee* in consideration for stock options is *not unenforceable* as a matter of law.[151] Though the *Marsh* Court explicitly did *not* decide the "reasonableness" issue under Section 15.50(a) of the Texas Business and Commerce Code (i.e., whether the covenant "contains limitations as to time, geographical area, and scope of activity to be restrained that are reasonable and do not impose a greater restraint than is necessary to protect the goodwill or other business interest of the promise,") leaving that issue to the trial court to determine, the Court ruled that the non-compete was enforceable because the stock option linked the employee's interests to the company's long-term interests, which could justifiably be protected with a non-compete agreement.[152] Thus, existing employees who have already been provided access to their employer's confidential and/or trade secret information may still enter into an enforceable non-compete agreement by offering another form of consideration such as stock options.

Second, employers should also have existing employees sign a non-disclosure agreement acknowledging that they understand that they are bound under Texas law not to disclose information that is proprietary and confidential and/or trade secret information belonging to the employer. The document should specify that this duty exists both during and after service to their current employer.

Third, employers should make clear to competitors and employees, to the extent possible without seeming imperious, that to the degree employees use or provide to new employers confidential, proprietary and/or trade secret information and/or copyrighted or patent-pending/patented information belonging to the employer, the employer will hold them liable. This can further serve to ensure that departing employees know that in addition to the restriction on their use of the former employer's confidential information, there will be consequences to violations of their duties.

Fourth, periodic training among executives and management about how to prevent and detect misappropriation of proprietary and/or trade secret information can be of great advantage to companies that rely on confidential information in their business. Such training can be presented or facilitated by in-house or outside counsel. In addition to prevention of misappropriation, training sessions can be used to teach management how to gather evidence of any ongoing suspicions and the importance of presenting evidence to counsel as soon as possible.

Finally, the company should hold exit-interviews with any and all departing employees who have had access to or been entrusted with trade secrets and/or proprietary information. The exit-interview is a perfect opportunity to explain the employee's rights *and* restrictions on their use of information acquired while employed. If the employer learns that misappropriation has occurred or will likely occur with the new employer, the company should send a strongly worded demand letter to the former employee and his new employer threatening suit and injunctive relief if the company discovers evidence of misappropriation.

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[150] TEX. BUS. & COM. CODE ANN. § 15.50.

[151] Marsh USA, Inc. v. Cook, 2011 Tex. LEXIS 941 (Tex. 2011).

[152] *Marsh*, 2011 Tex. LEXIS 465, at *36.

VI. CONCLUSION

At the close of 2006, the U.S. District Court for the Southern District of Texas revisited the Doctrine in *Anadarko Petroleum Corp. v. Davis, et al*.[153] In *Anadarko*, Davis, a petroleum engineer, and Molleston, a senior landman, were employed by Anadarko.[154] Anadarko's predecessors had employed Davis for almost twenty years prior to Anadarko's merger with those companies.[155] In the summer of June 2006, both Molleston and Davis left to work for GeoSouthern, a company that had worked closely with Anadarko, Molleston, and Davis on several occasions.[156] At no point did Anadarko require Davis or Molleston to sign a noncompete agreement, only a statement agreeing to abide by the company's code of ethics, which addressed the use of confidential and proprietary information.[157]

The Court noted specifically in its fact recitation that Anadarko did not take the position that "as a result of working at Anadarko for such a long time, Davis. . .knew so much about the geographic areas where they worked as to make disclosure or use of that information inevitable if they worked for a competitor in the same area."[158] It is worth noting that the Court later refused to expand the injunction against Davis to prevent him from working for GeoSouthern.[159] The only explanation for the court's use of the language is that the Court inferred that had Anadarko alleged applicability of the Doctrine, the Court may have been willing to also prevent Molleston and, especially, Davis from working for GeoSouthern in any capacity.

Instead, the court held that under Texas law, "when a former employee misappropriates his employer's trade secrets, the appropriate remedy is to enjoin use and disclosure of those secrets, not to enjoin work in competition with the former employer."[160] The Court may have been relatively more lenient to Davis due to his candor during injunction proceedings, in which he admitted that he acquired Anadarko's confidential and proprietary information without authorization.[161] If nothing else, it seems that where an employee takes and utilizes confidential information of a previous employer, the Doctrine may be the only way to prevent that employee from using the information either intentionally or subconsciously by enjoining him or her from working for a direct competitor in the first place.

In a comparable ruling, *Baker Hughes Oilfield Operations, Inc., et al. v. Pathfinder Energy Services, Inc, et al.*,[162] the U.S. District Court for the Southern District of Texas ordered a preliminary injunction in September 2007, preventing the defendant from working for

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153 Anadarko v. Davis, No. H-06-2849, 2006 WL 3837518 (S.D. Tex. Dec. 28, 2006).

154 *Id.* at *2.

155 *Id.*

156 *Id.*

157 *Id.*

158 Anadarko v. Davis, No. H-06-2849, 2006 WL 3837518, at *3.

159 *Id.* at *28.

160 *Id.* at *24.

161 *Id.* at *16.

162 Baker Hughes Oilfield Operations, Inc. v. Pathfinder Energy Servs., Inc, No. 4:07-cv-2623 (S.D. Tex. Sep. 26, 2007) (order granting preliminary injunction).

Plaintiff's competitor "in any area which poses an inherent threat of disclosure or use of [Plaintiff's] Trade secrets" for one year.[163]

Yet, in the 2009 case of *M-I, L.L.C. v. Stelly*, the U.S. District Court for the Southern District of Texas went against the idea of "inherent threat of disclosure or use" to rule that former employees, whose jobs at the plaintiff's company innately exposed them to trade secrets and who had since moved on to a competitor's company, were not automatically injurious [to the interests of the plaintiff] merely because of their trade secret exposure, and, where there is no knowledge or proof of misuse of confidential information or injury, irreparable harm is not presumed.[164]

As more courts examine the applicability of the Doctrine of Inevitable Disclosure, it is possible that different standards will be applied depending on the circumstances under which the employee left the company.[165] For example, some have authorities have suggested that employees should be given more latitude in selecting a new employer when he or she has been involuntarily terminated without cause rather than when he or she has left to go work for a competitor.[166] However, the purpose of the Doctrine is to protect sensitive and valuable information, not protection of either the former employer or employee.

Ultimately, whether the adoption of the Doctrine in Texas is inevitable depends upon whether our courts are willing to circumvent the existing requirement of imminent, actual and substantial injury when there is no non-compete agreement and no evidence that trade secrets have or will be unlawfully transferred in order to prevent their possible disclosure.

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[163] *Id.* at *3.

[164] M-I, L.L.C. v. Stelly, No. H-09-cv-01552, 2009 U.S. Dist. LEXIS 65866 (S.D. Tex. July 30, 2009).

[165] *IP/Tech Advisor, De Facto Non-Competition Agreements: The Inevitable Disclosure Doctrine*, Aug, 9, 2001, http://www.inc.com/articles/2001/08/23292.html.

[166] *Id.*

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JOINT VENTURE FORMATION

Byron F. Egan*

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I. INTRODUCTION

The joint venture is a vehicle for the development of a business opportunity by two or more entities acting together,[1] and will exist if the parties have: (1) a community of interest in the venture, (2) an agreement to share profits; (3) an agreement to share losses, and (4) a mutual right of control or management of the venture.[2] A joint venture may be structured as a corporation, partnership, limited liability company (***"LLC"***), trust, contractual arrangement, or any combination of such entities and arrangements.[3] Structure decisions for a particular joint venture will be driven by the venturers' tax situation, accounting goals, business objectives and financial needs, as well as the venturers' planned capital and other contributions to the venture, and antitrust and other regulatory considerations.[4] Irrespective of the structure chosen, however, certain elements must be considered in connection with structuring every joint venture.

Because a joint venture is commonly thought of as a limited duration general partnership formed for a specific business activity, the owners of a joint venture are sometimes referred to herein as *"partners"* or *"venturers,"* and the joint venture as the *"entity," "partnership"* or *"venture,"* in each case irrespective of the particular form of entity or other structure selected for the joint venture.

II. JOINT VENTURE FORMATION

A. Choice of Entity

A joint venture may take the form of:

(1) <u>Contractual Relationship Not Constituting an Entity Recognized by Statute</u>. The joint venturers may operate under a relationship such as a contractual revenue-sharing joint venture, a lease, a creditor/debtor relationship or some other relationship not constituting an entity. A risk to this structure is that a court will impose general partnership duties or liabilities on the venturers if their relationship is found to constitute "an association of two or more persons to operate a business as co-owners for a profit" (the traditional definition of a partnership) regardless of how the venturers characterize and document their relationship.[5] In determining whether the relationship is a partnership, the following factors are considered:

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[1] *See* James R. Bridges and Leslie E. Sherman, *Structuring Joint Ventures*, 4 INSIGHTS 17 (Oct. 1990); David Ernst and Stephen I. Glover, *Combining Legal and Business Practices to Create Successful Strategic Alliances*, 11 INSIGHTS 6 (Oct. 1997); Stephen I. Glover, *Joint Ventures and Opportunity Doctrine Problems*, 9 INSIGHTS 9 (Nov. 1995); Warren S. de Wied, *Structuring Strategic Equity Investments*, 1 No. 8 M&A Law. 7 (Jan. 1998).

[2] Pitts & Collard, L.L.P. v. Schechter, No. 01-08-00969-CV, 2011 WL 6938515, at *11 (Tex. App.—Hous. [1st Dist.] Dec. 29, 2011). For additional discussion of whether the agreement is, in fact, a joint venture, see *id.* at *11-12.

[3] *See* JOINT VENTURE TASK FORCE OF NEGOTIATED ACQUISITIONS COMMITTEE, MODEL JOINT VENTURE AGREEMENT WITH COMMENTARY (Am. Bar Ass'n., 2006).

[4] *See* Byron F. Egan, *Business Entities in Texas after 2011 TexasLegislature*, TexasBarCLE program on Legislative Changes Affecting Business Entities, July 13, 2011, *available at* http://images.jw.com/com/publications/1629.pdf ("Business Entities Paper")

[5] In *Derrick Resources, Inc. v. David Wilstein, et al*, 312 S.W.3d 864,877 (Tex. App.– Houston [1st Dist.] 2009, no pet.), which involved an oil and gas drilling and production arrangement pursuant to a contract that was called a "joint venture agreement," the Court in an opinion by Justice Evelyn Keyes held that the joint venture agreement created a fiduciary relationship that imposed a fiduciary duty of full and fair disclosure on the managing venturer as it held title to the venture's properties in its name and had a power of attorney to dispose of the properties, and explained:

•Receipt or right to receive a share of profits;

•Expression of an intent to be partners;

•Participation or right to participate in control of the business;

•Sharing or agreeing to share losses or liabilities; or

•Contributing or agreeing to contribute money or property to the business.[6]

A contract is sometimes used to establish the relationship among the venturers even though one of the entities referenced below may be the operating vehicle for the joint venture.

(2) General Partnership. A general partnership is an unincorporated association of two or more persons to operate a business as co-owners for profit that is not formed under another statute.[7] The definition of a partnership under Texas general partnership statutes includes a "joint venture" or any other named association that satisfies the definition of "partnership."[8] A joint venture may be legally nothing more than a limited purpose general partnership, although a joint venture may be organized as a corporation, limited partnership or LLC.[9] A general partnership may become a limited liability partnership (***"LLP"***), which is a general partnership in which the partners are not vicariously liable to third parties for some or all partnership obligations if it makes the requisite filings with the appropriate state secretary of state and complies with certain other state statutory requirements.[10]

(3) Limited Partnership. A limited partnership is a partnership having at least two partners including at least one limited partner and at least one general partner, and that files a

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Joint venturers for the development of a particular oil and gas lease have fiduciary duties to each other arising from the relationship of joint ownership of the mineral rights of the lease. [citation omitted] Likewise, if there is a joint venture between the operating owner of an interest in oil and gas well drilling operations and the non-operating interest owners, the operating owner owes a fiduciary duty to the non-operating interest owners. [citation omitted] In addition, "[a]n appointment of an attorney-in-fact creates an agency relationship," and an agency creates a fiduciary relationship as a matter of law. [citation omitted] The scope of the fiduciary duties raised by a joint venture relationship, however, does not extend beyond the development of the particular lease and activities related to that development.

The dispute revolved around the manager's sale of parts of its interest after giving oral notice to the other venturer, but not the written notice accompanied by full disclosure specified in the agreement. The opinion is lengthy and very fact specific, but the following lessons can be drawn from it: (i) calling a relationship a joint venture can result in a court categorizing the relationship as fiduciary, which in turn implicates duties of candor and loyalty and could implicate the common law corporate opportunity doctrine, (ii) it is important to document the relationship intended (an LLC could be used as the joint venture entity and the LLC company agreement could define or in Delaware eliminate fiduciary duties), and (iii) written agreements should be understood and followed literally.

[6] *See* Brown v. Keel, No. 01-10-00936-CV, 2012 WL 760933, at *4 (Tex. App.—Hous. [1st Dist.] March 8, 2012) (citing Ingram v. Deere, 288 S.W. 3d 886, 896 (Tex. 2009)); Westside Wrecker Serv., Inc. v. Skafi, ___ S.W. 3d ____, 2011 WL 5617748, at *9 (Tex. App.—Hous. [1st Dist.] Nov. 17, 2011); Hoss v. Alardin, 338 S.W.3d 635, 641-42 (Tex. App.—Dallas 2011). *See also* Business Entities Paper, *supra* note 4, at *76.

[7] Egan, *supra* note 4, at 78.

[8] TEX. BUS. ORGS. CODE ANN. § 152.051(b) (Vernon 2011).

[9] *See* Alan R. Bromberg and Larry E. Ribstein, *Bromberg & Ribstein on Partnership*, § 2.06 (Aspen Publishers 2010).

[10] Egan, *supra* note 4, at 147-162.

certificate of limited partnership with the applicable state secretary of state.[11] A limited partnership can be structured in some states as a limited liability limited partnership (***"LLLP"***), which is a limited partnership in which general partners are not vicariously liable to third parties for some or all partnership obligations.[12]

(4) Limited Liability Company. A limited liability company (***"LLC"***) is an unincorporated organization formed by one or more persons filing a certificate of formation or articles of organization under a state limited liability company act.[13] None of the members of an LLC are personally liable to a third party for the obligations of the LLC solely by reason of being a member.[14]

(5) Corporation. A corporation is a business organization usually formed under a state corporation law, but occasionally is formed under federal law such as certain banking organizations.[15]

There are several factors typically considered in determining the appropriate form of entity or other structure for a joint venture. Key elements usually are:

- How the entity and the venturers will be taxed under federal and state law;[16] and

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[11] *Id.* at 88-105.

[12] *Id.* at 164.

[13] *Id.* at 106-147.

[14] *Id.* at 106.

[15] *Id.* at 52-75.

[16] Federal and state taxation of an entity and its owners for entity income is a major factor in the selection of the form of entity for a particular situation. Under the United States (*"U.S."*) Internal Revenue Code of 1986, as amended (the *"IRC"*), and the *"Check-the-Box Regulations"* promulgated by the Internal Revenue Service (*"IRS"*) (Treasury Regulations §§ 301.7701-1, -2 and -3), an unincorporated business entity may be classified as an "association" taxable as a corporation subject to income taxes at the corporate level ranging from 15% to 35% of taxable net income, which is in addition to any taxation which may be imposed on the owner as a result of distributions from the business entity. Alternatively, the entity may be classified as a partnership, a non-taxable "flow-through" entity in which taxation is imposed only at the ownership level. Although a corporation is classified only as a corporation for IRC purposes, an LLC or partnership may elect whether to be classified as a partnership. A single-owner LLC is disregarded as a separate entity for federal income tax purposes unless it elects otherwise. *See* Byron F. Egan, *Business Entities in Texas after 2011 Texas Legislature*, Texas Bar CLE webcast on Legislative Changes Affecting Business Entities, Texas Bar CLE Webcast, July 13, 2011, at 15-19, *available at* http://images.jw.com/com/publications/1629.pdf.

In addition to federal tax laws, an entity and its advisors must comply with federal anti-money laundering and terrorist regulations. An entity and its advisors are charged with reviewing and complying with the Specially Designated Nationals List (*"SDN List"*) maintained by the Office of Foreign Assets Control (*"OFAC"*) within the U.S. Department of Treasury. U.S. citizens and companies (subject to certain exclusions typically conditioned upon the issuance of a special license) are precluded from engaging in business with any individual or entity listed on the SDN List. The SND List and OFAC guidance are available on the OFAC website at http://www.ustreas.gov/offices/enforcement/ofac/.

Texas does not have a state personal income tax. The Texas Legislature has replaced the Texas franchise tax on corporations and LLCs with a novel business entity tax called the *"Margin Tax,"* which is imposed on all business entities other than general partnerships wholly owned by individuals and certain "passive entities." Essentially, the calculation of the Margin Tax is based on a taxable entity's, or unitary group's, gross receipts after deductions for either (x) compensation or (y) cost of goods sold, provided that the "tax base" for the Margin Tax may not exceed 70% of the entity's total revenues. This "tax base" is apportioned to Texas by multiplying the tax base by a fraction of which the numerator is Texas gross receipts and the denominator is aggregate gross receipts. The tax rate applied to

- Who will be liable for its contract, tort and statutory obligations (the entity itself will always be liable to the extent of its assets; the question is whether owners will be liable if entity's assets are insufficient to satisfy all claims).

Although these two considerations tend to receive the principal focus in the entity choice decision, other factors can be critical: (a) the application of non-tax laws and regulations to the venture and the venturers, (b) the ability of the venturers to order their duties and rights by agreement (e.g. limitation of fiduciary duties), (c) the venturers' exit strategies, (d) the manner in which the venturers will share the economic benefits of the venture, (e) the possible need for additional contributions by new and existing venturers, (f) the manner in which the venturers will make day-to-day and policy decisions of the venture, (g) the agency rules applicable to the venture and (h) particular requirements of the venture's business.

Increasingly, the LLC is the form of entity chosen for domestic joint ventures in the U.S.[17] The allure of the LLC is its unique ability to bring together in a single business organization the best features of all other business forms. Owners of a properly structured LLC can obtain both a corporate-styled liability shield and the pass-through tax benefits of a partnership. All equity holders of an LLC have the limited liability of corporate shareholders even if they participate in the business of the LLC. Under the Check-the-Box Regulations, a domestic LLC with two or more members typically would be treated for federal income tax purposes as a partnership.[18] An LLC is subject to Texas Margin Tax.

An underlying premise of the Texas and Delaware LLC statutes is that the LLC is based in large part upon a contract between its members, similar to a partnership agreement. As a result, fundamental principles of freedom of contract imply that the owners of an LLC have maximum freedom to determine the internal structure and operation of the LLC.[19] Most of the provisions relating to the organization and management of an LLC and the terms governing its equity interests are contained in the LLC's company agreement, which will typically contain provisions similar to those in limited partnership agreements and corporate bylaws,[20] and may also constitute the joint venture agreement for a joint venture organized as an LLC.[21]

The identity of the specific entities through which the venturers will participate in the venture is another key initial decision. If the joint venture is structured as a partnership, special purpose subsidiaries will typically be used in order to insulate the venturers from liabilities incurred by the venture. A venturer may desire to use a special purpose subsidiary to facilitate a subsequent transfer of all or a portion of its interest in the venture. The use of special purpose subsidiaries may lead to requests for parent company guarantees of subsidiary obligations to other venturers and to the entity.

the Texas portion of the tax base is 1% for all taxpayers, except a narrowly defined group of retail and wholesale businesses that will pay a ½ of 1% rate. For calendar year taxpayers, the Margin Tax is payable annually on May 15 of each year based on entity income for the year ending the preceding December 31.

[17] Rodney D. Chrisman, *LLCs are the New King of the Hill: An Empirical Study of the Number of New LLCs, Corporations, and LPs Formed in the United States between 2004-2007 and How LLCs Were Taxed for Tax Years 2002-2006*, XV FORDHAM J. CORP. & FIN. L. 459 (2010), *available at* http://www.abanet.org/dch/committee.cfm?com=CL590000.

[18] Egan, *supra* note 4, at 2

[19] *Id.* at 114-117.

[20] TEX. BUS. ORGS. CODE ANN.§ 101.052 (Vernon 2010); Joint Task Force of the Committee on LLCs, Partnerships and Unincorporated Entities and the Committee on Taxation, ABA Section of Business Law, *Model Real Estate Development Operating Agreement with Commentary*, 63 BUS. LAW. 385 (2008).

[21] *See* JOINT VENTURE TASK FORCE OF NEGOTIATED ACQUISITIONS COMMITTEE, *supra* note 2, at 38.

In addition to the form of entity or arrangement, the organizers need to choose the particular state laws that are to govern the entity. States like Delaware and Texas, which have well-developed statutes and case law relating to the relationship between owners of the joint venture and managers of the entity, are preferable to states where the law is not as well recognized. The state of organization also may affect where evidences of lien rights ("financing statements") need to be filed under Article 9 of the Uniform Commercial Code in secured lending arrangements, and where bankruptcy proceedings may be commenced.

B. Scope and Purpose

A central element of every joint venture is the scope of its business, both as to the types of products, services or technology which the venture is organized to provide, and as to the geographic area or markets in which they will be provided.[22] Where the business of the venture is similar to the existing business of one or more of the venturers, it may be necessary to contractually define the activities that may be conducted by the venturers only through the venture and those which the parties may conduct separately.[23]

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[22] *Id.* at xv-xviii.The ABA Model Joint Venture Agreement was prepared based on an assumed fact pattern in which the proposed joint venture is a Delaware LLC with two members, one of whom has a 60% equity interest (*"Large Member"*) and one of which has a 40% equity interest (*"Small Member"*), and both of which are engaged in manufacturing and selling high tech equipment. They want to contribute their assets relating to existing products to the joint venture on its formation, and collaborate through the joint venture in developing and marketing the next generation of high tech equipment, which they know will have be smaller and more efficient. Although they are competitors, neither has a significant market share in their common products. Independently they will continue to manufacture and distribute other products. Based on this fact pattern, the ABA Model Joint Venture Agreement sets forth in recitals at the front definitions of the "Business" of the proposed joint venture and other terms that will be used throughout the Agreement to define the purposes of the joint venture, which in turn will be used to restrict other activities of the venturers elsewhere in the Agreement, as follows:

A. Large Member, through its High Tech Division, and Small Member are each currently engaged in the research, development, manufacturing and distribution of __________________ products ("Initial Products"), that each will manufacture on a toll basis for the joint venture and that will be distributed by the joint venture.

B. Large Member, through its High Tech Division, currently distributes its Initial Products in the United States and elsewhere in the world, and Small Member currently distributes its Initial Products in the United States.

C. Large Member and Small Member desire to form a joint venture as a Delaware limited liability company (the "Company") for the distribution of Initial Products and for the research, development, manufacture and distribution of ______________ products that are not Initial Products ("New Products;" and with such activities as to the Initial Products and the New Products being the "Business").

[23] *Id.* at 182-86. Article 15 of the ABA Model Joint Venture Agreement prohibits a member from competing with the joint venture during the period it holds an interest therein, and for a specified period thereafter, as follows:

Article 15: Competition

15.1 Competition.

(a) *Generally*. Each Member will not, and will take all actions necessary to ensure that its Affiliates will not, engage in the activities prohibited by this Section 15.1. For purposes of this Section 15.1, the ''Restricted Period'' for a Member lasts for so long as it or any of its Affiliates owns any interest in the Company. In addition, in the case of a Member whose Member Interest is purchased pursuant to Article 10 (Buy-Sell in the Absence of Default) or pursuant to Article 11 (Buy-Sell Upon Default), the Restricted Period lasts until the last day of the 60th full calendar month following the date on which the purchase is closed. Further, in the case of a Member that does not continue the Company's Business following the dissolution of the Company in which the Company's Business is continued by the other Member or by a third party purchaser, the Restricted Period lasts until the last day of the 60th full calendar month following the date on which the Company is wound up.

A related issue is the extent of the exclusivity of the joint venture. What happens if the joint venture does not have the funds to pursue particular prospects, projects or opportunities within its scope? Further, where the joint venture has its own managers, what will happen if the managers decide not to pursue a particular project or market? Alternatives for dealing with these issues include: (i) make exclusivity absolute (e.g., even though the joint venture cannot or does not pursue a specific opportunity falling within its "scope," all participants are barred from doing so); (ii) allow each participant separately to pursue opportunities which are within the "scope" of the joint venture and which the joint venture management decides not to pursue; or (iii) where one or more participants, but not the required number of participants, vote for the venture to fund and pursue a particular opportunity, only those participants which

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(b) *Restricted Activities*. Neither the Member nor any of its Affiliates will:

(i) *Non-Competition*: during the Restricted Period, carry on or be engaged, concerned or interested directly or indirectly whether as shareholder, partner, director, employee, member, agent or otherwise in carrying on any business similar to or competing with the Business anywhere in the United States (other than as a holder of not more than five percent of the issued voting securities of any company listed on The Nasdaq Stock Market or any registered national securities exchange);

(ii) *Non-Solicitation of Customers*: during the Restricted Period, either on its own account or in conjunction with or on behalf of any other Person, solicit or entice away or attempt to solicit or entice away from the Company as a customer for the products or services of the Business any Person who is, or at any time within the prior 24 months has been, a customer, client or identified prospective customer or client of the Company;

(iii) *Non-Solicitation of Employees*: during the Restricted Period, either on its own account or in conjunction with or on behalf of any other Person, employ, solicit or entice away or attempt to employ, solicit or entice away from the Company, any Person who is or will have been at the date of or within 24 months before any solicitation, enticement or attempt, an officer, Manager, consultant or employee of the Company or of the other Member, whether or not that Person would commit a breach of contract by reason of leaving employment; *provided, however,* that the foregoing does not restrict a Member from employing a Manager or officer who was an employee of that Member while serving as a Manager or as an officer of the Company nor does it restrict a Member's general advertisements with respect to a position that are not directed to officers, Managers, consultants or employees of the Company, and *provided, further,* that the Members may agree from time to time that this Section does not apply to specified persons; and

(iv) *Restriction on Use of Trademark and Trade name*: at any time hereafter in relation to any trade, business or company use a name including the word [or symbol] [''__________''] or any similar word [or symbol] in a way as to be capable of or likely to be confused with the name of the Company.

15.2 Distribution. The Company may enter into distribution agreements with independent distributors who currently are distributing products manufactured by a Member. A Member whose products are distributed by an independent distributor after the Closing will not be considered to have breached its obligations under Section 15.1 by virtue of those distribution arrangements. Each Member hereby waives any claim it may have under existing distribution agreements with independent distributors that an independent distributor would have breached of its non-competition obligations under that existing distribution agreement by distributing Products under a distribution agreement with the Company.

15.3 Independent Agreements. The agreements set forth in this Article 15 (and in each Section or other part of this Article 15) are, will be deemed, and will be construed as separate and independent agreements. If any agreement or any part of the agreements is held invalid, void or unenforceable by any court of competent jurisdiction, then such invalidity, voidness or unenforceability will in no way render invalid, void or unenforceable any other part of the agreements; and this Article 15 will in that case be construed as if the void, invalid or unenforceable provisions were omitted.

15.4 Scope of Restrictions. While the restrictions contained in this Article are considered by the Members to be reasonable in all the circumstances, it is recognized that restrictions of the nature in question may not be enforced as written by a court. Accordingly, if any of those restrictions are determined to be void as going beyond what is reasonable in all the circumstances for the protection of the interest of the Members, but would be valid if restrictive periods were reduced or if the range of activities or area dealt with were reduced in scope, then the periods, activities or area will apply with the modifications as are necessary to make them enforceable.

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voted in favor of pursuing the opportunity may pursue it if the venture does not. Where the parent company or any affiliates of a participant have the ability to compete with the joint venture, it may be necessary to get the agreement of such companies, or the covenant of the participant to cause such companies, not to compete with the joint venture.

Because common law "business opportunity" doctrines may impose fiduciary duties on the partners to offer business opportunities to the venture,[24] joint venture agreements typically define carefully the scope of the contemplated business of the venture and the extent to which partners may compete with the venture or pursue opportunities that the venture might undertake. Often these matters are dealt with in a separate business opportunity agreement.

C. Funding

Mechanisms should be established for funding the joint venture's activities – both for initial funding and for additional funding during the life of the joint venture. The joint venture's governing documents should state the participants' rights and obligations to make mandatory and optional cash contributions, as well as mandatory and optional loans to the joint venture entity.[25]

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[24] *See* Byron F. Egan, *How Recent Fiduciary Duty Cases Affect Advice to Directors and Officers of Delaware and Texas Corporations*, University of Texas School of Law 34th Annual Conference on Securities Regulation and Business Law, Dallas, TX, February 10, 2012, at 78-82, *available at* http://images.jw.com/com/publications/1712.pdf; *see also* Byron F. Egan, *Good Faith, Fair Dealing and Other Contractual and Fiduciary Issues*, University of Texas School of Law 2009 Partnerships and LLCs Conference, Austin, TX, July 23, 2009, at 68-70, 78-85 and 102-11, *available at* http://images.jw.com/com/publications/1220.pdf; Kevin G. Abrams and Srinivas M. Raju, *Recent Developments in the Corporate Opportunity Doctrine Under Delaware Law*, 10 INSIGHTS 2 (1996).

[25] JOINT VENTURE TASK FORCE OF NEGOTIATED ACQUISITIONS COMMITTEE, *supra* note 2, at 59-64. Article 3 of the ABA Model Joint Venture Agreement provides for initial and additional capital contributions, as well as loans, by the venturers as follows:

Article 3: Capital Contributions

3.1 Initial Capital Contributions. Immediately after the completion of the capital contributions for which Section 2.8 (Closing Deliveries) provides, the parties agree that the Book Capital Account of each Member is as follows:

<u>NameInitial Book Capital Account</u>

Large Member $

Small Member $

3.2 Additional Capital Contributions and Member Loans.

(a) *Mandatory Only If Included in Business Plan*. Each Member will make additional capital contributions (''Additional Capital Contributions'') or loans (''Member Loans'') to the Company in accordance with its Member Interest, but only in the amounts and at the times set forth in the Business Plan as it may be amended from time to time. Neither Member is otherwise required to contribute capital or make Member Loans to the Company.

(b) *Procedure*.

(i) *Generally*. All requirements or requests for Additional Capital Contributions or Member Loans will: (A) be in a notice delivered to each Member by the CEO stating that the Additional Capital Contribution has been approved by the Management Committee in accordance with Section 5.4 (Actions Requiring Management Committee Approval—Major); (B) state the aggregate amount of Additional Capital Contributions or Member Loans and the amount of each Member's share of such Additional Capital Contribution or Member Loan; and (C) specify the date that the Additional Capital Contribution or Member Loan is to be made, which will not be sooner than twenty Business Days following the Member's receipt of the notice.

(ii) *Accompanying Certificate*. The Members will deliver certificates to the Company and to each other, dated as of the date the Additional Capital Contribution or Member Loan is to be made, that contain reasonable representations and warranties as to such matters as is appropriate (for example, to establish the ability of the Member to comply with its obligations under the Business Plan). In addition, if Additional Capital Contributions are to consist of property other than cash, such certificate will contain reasonable representations and warranties as to the ownership and condition of any such property.

(c) *The Member Loans*. Each Member Loan will be evidenced by a promissory note bearing interest at a fluctuating rate equal to six percentage points over the Prime Rate, but not in excess of any legally permitted rate of interest (the ''Specified Interest Rate''). ''Prime Rate'' means the prime rate as published in the ''Money Rates'' table of *THE WALL STREET JOURNAL* on the first publication day of the calendar quarter in which the loan was made and as adjusted as of the first publication day of each subsequent calendar quarter until paid. Each Member Loan will (i) be for such term and subject to such security, if any, as determined by the Management Committee, (ii) if necessary to secure financing for the Company, be subordinated to any other indebtedness of the Company or a portion of it, (iii) become due and payable in the event the Company is dissolved, (iv) rank pari passu with any and all other Member Loans and (v) be nonrecourse as to the other Member.

3.3 Failure of a Member to Make a Required Additional Capital Contribution or Make a Required Member Loan. If a Member (the ''Non-Contributing Member'') fails to make a required Additional Capital Contribution or make a required Member Loan when due, the other Member (the ''Other Member'') may exercise one or more of the following remedies (but shall not be entitled to any other remedy either in the name of the Other Member or in the name of the Company).

(a) *Proceeding to Compel*. Institute a proceeding either in the Other Member's own name or on behalf of the Company to compel the Non-Contributing Member to contribute the Additional Capital Contribution or Member Loan.

(b) *Loan by Other Member*. Loan to the Company on behalf of the Non-Contributing Member the amount of the Additional Capital Contribution or Member Loan due from the Non-Contributing Member (''Shortfall Loan''), in which case the Non-Contributing Member: (i) will be liable to the Other Member for the amount of such Shortfall Loan, plus all expenses incurred by the Other Member (not including any interest incurred by the Other Member in borrowing the funds used to fund the Shortfall Loan) and the Company in connection with such Shortfall Loan, including reasonable attorneys' fees, and interest at the Specified Interest Rate; and (ii) hereby grants the Other Member a lien on its Member Interest to secure repayment of the Shortfall Loan and constitutes the Other Member as its attorney in fact to file a financing statement on form UCC-1 to perfect such lien; *provided, however,* that the rights under such lien may be exercised by the Other Member only in connection with exercising its rights to purchase such Member's Member Interest in accordance with Section 8.2(a) (Material Default). The Non-Contributing Member will deliver to the Other Member the certificate representing its Member Interest as security for such lien. Any distributions otherwise due from the Company to the Non-Contributing Member will be applied as described in Section 4.4 (Payment of Distributions if Shortfall Loans Outstanding). The Non-Contributing Member will repay the Shortfall Loan in 20 equal quarterly installments plus interest at the Specified Interest Rate. The Non-Contributing Member's failure to make any such payment when due is a Material Default under Section 8.2(a).

(c) *Other Borrowings*. Borrow on behalf of the Company from a lender other than the Other Member the amount of the Additional Capital Contribution or Member Loan due from the Non-Contributing Member on such terms as the Other Member, in its sole discretion, may be able to obtain. In this case, the Non-Contributing Member will be liable to the Company for the principal amount of, and interest on, such borrowing, plus all expenses reasonably incurred by the Company in connection with such borrowing, including reasonable attorneys' fees (also a ''Shortfall Loan''). The Non-Contributing Member's failure to make any such payment when due is a Material Default under Section 8.2(a) (Material Default). The Non-Contributing Member does hereby grant to the Company a lien on its Member Interest to secure repayment of the Shortfall Loan and constitutes the Other Member as its attorney in fact to file a financing statement on form UCC-1 to perfect such lien. The Non-Contributing Member will deliver to the Company the certificate representing its Member Interest as security for such lien. Any distributions otherwise due from the Company to the Non-Contributing Member will be applied as described in Section 4.4 (Payment of Distributions if Shortfall Loans Outstanding).

(d) *Refuse to Make Capital Contribution*. Refuse to make any Additional Capital Contributions or Member Loans to the Company without being in default of any provision of this Agreement.

(e) *Exercise of Article 8 Rights*. Exercise its rights under Article 8 (Dis-solution and Other Rights upon De-

Typically, procedures will be put in place whereby the participants, either directly or through their representatives on the joint venture's board of directors or board of managers, agree upon an annual budget for the venture.[26] Cash required from the participants to fund the venture's operations under the agreed budget is then frequently provided on the call of the venture's senior manager, based on an agreed schedule. An issue related to the cash funding of the joint venture is the contribution of services, technology, products, or other assets to the joint venture. To the extent that a participant will be making any such non-cash contributions, a procedure should be established at the outset of the venture for the valuation of such contributions.

D. Allocations and Distributions

Subject to various limitations imposed by tax laws, the participants have great flexibility in structuring the allocation and distribution of profits, losses, and other items.[27] For ex-

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fault).

3.4 No Withdrawal of or Payment of Interest on Capital. No Member will have any right to withdraw or make a demand for withdrawal of all or any portion of its Book Capital Account. No interest or additional share of profits will be paid or credited to the Members on their Book Capital Accounts.

[26] *Id.* at 86-9. Section 5.8 of the ABA Model Joint Venture Agreement provides for business plans and budgets of the joint venture as follows:

5.8 Business Plan.

(a) *Initial Business Plan*. The initial business plan (''Business Plan'') attached as Exhibit One covers the first five years of the Company's proposed operations and identifies the items that (i) the Members deem to be critical to the Company's success (a ''Critical Target'') and (ii) if not met, will give one or both Members the rights described in Section 7.2(a) (Fundamental Failure). The Business Plan will include a budget prepared in accordance with Section 5.8(b). The Members intend that the Business Plan be reviewed or modified, as applicable, at least annually. At least 120 days before the beginning of each Fiscal Year, the CEO will deliver to the Management Committee any proposed modifications in the Business Plan.

(b) *Budget Contents*. The budget will include:

(i) a projected income statement, balance sheet and operational and capital expenditure budgets for the forthcoming Fiscal Year;

(ii) a projected cash flow statement showing in reasonable detail: (A) the projected receipts, disbursements and distributions; (B) the amounts of any corresponding projected cash deficiencies or surpluses; and (C) the amounts and due dates of all projected calls for Additional Capital Contributions for the forthcoming Fiscal Year; and

(iii) such other items requested by the Management Committee.

(c) *Consideration of Proposed Plans*. Each proposal to continue or modify a Business Plan will be considered for approval by the Management Committee at least 90 days before the beginning of the Fiscal Year to which it pertains. The Management Committee may revise the proposed Business Plan or direct the CEO to submit revisions to the Management Committee.

(d) *Continuation of Existing Business Plan*. Until a revised Business Plan is approved, the Company will be managed consistently with the last Business Plan approved by the Management Committee, adjusted as necessary to reflect the Company's contractual obligations and other changes that result from the passage of time or the occurrence of events beyond the control of the Company.

[27] *Id.* at 64-9. Article 4 of the ABA Model Joint Venture Agreement provides for the allocation of profits and losses and distributions as follows:

Article 4: Allocation of Profits and Losses; Distributions

4.1 Shares of Profits and Losses. Each Member will share in the Company's profits and losses in accordance with its Member Interest. A Member's share of the taxable income or loss or other tax items of the Company will be determined in accordance with Attachment 12 (Tax Provisions).

4.2 Definitions.

(a) *Cash Flow from Operations*. ''Cash Flow from Operations'' means all cash available to the Company from its Ordinary Course of Business activities remaining after payment of current expenses, liabilities, debts or obligations of the Company (other than principal or interest on Member Loans).

(b) *Other Available Cash*. ''Other Available Cash'' means cash generated by the Company's activities outside its Ordinary Course of Business activities.

(c) *Tax Amount*. The ''Tax Amount'' is the product of (i) the Effective Tax Rate and (ii) the Company's Cumulative Net Taxable Income. The Tax Amount will not be in excess of the product of (A) the Effective Tax Rate and (B) the Company's taxable income for the Fiscal Year of the determination. For purposes of the foregoing:

(i) *Effective Tax Rate*. The ''Effective Tax Rate'' is the highest U.S. corporate income tax rate for that year plus the federal tax-effected state and local income tax rate in effect at the principal office of the Company.

(ii) *Cumulative Net Taxable Income*. The ''Cumulative Net Taxable Income'' is determined at the end of the Company's Fiscal Year with respect to which the Tax Amount is to be determined and is the sum of all taxable income for the current and all prior Fiscal Years reduced by the sum of all taxable losses for the current and all prior Fiscal Years.

4.3 Distributions. Distributions are made in the following priority:

(a) *Distribution of Tax Amount*. At least ten Business Days before each date when a U.S. corporate estimated income tax payment is due, the Company will distribute, from Cash Flow from Operations (or, if necessary, from Other Available Cash), to each Member its share of the Tax Amount estimated by the Company to have accrued during the estimated tax period before the distribution date. No later than 65 days after the end of the Company's Fiscal Year, the Company will distribute, from Cash Flow from Operations (or, if necessary, from Other Available Cash), to each Member its share of any previously unpaid Tax Amount for such Fiscal Year.

(b) *Reserves*. The Management Committee will establish reserves from Cash Flow from Operations for:

(i) contingent or unforeseen obligations, debts or liabilities of the Company, as the Management Committee deems reasonably necessary;

(ii) amounts required by any Contracts of the Company; and

(iii) such other purposes as decided upon by the Management Committee.

(c) *Pay Member Loans*. Member Loans will be paid from Cash Flow from Operations (or, if necessary, from Other Available Cash) as follows:

(i) If the terms of Member Loans state the order of priority of payment of principal and interest, then those priority rules will apply.

(ii) Otherwise, the Company: (A) first will pay interest due on the Member Loans, on a proportionate basis without preference, in accordance with the total amount of interest outstanding on all Member Loans; and (B) then will pay the principal due on the Member Loans, on a proportionate basis without preference, in accordance with the total amount of principal outstanding on all Member Loans.

(d) *The Balance*. Subject to Section 4.4, the Company will distribute the balance, if any, of Cash Flow from Operations to the Members in accordance with their Member Interests within 90 days after the end of the Company's Fiscal Year.

(e) *Other Available Cash*. Distributions of Other Available Cash are to be made in such amounts and at such times as determined by the Management Committee, taking into account the needs of the Company and the distribution policy set forth in Section 4.8. If there is not enough Cash Flow from Operations to make all the distributions provided for in Sections 4.3(a) and 4.3(c), Other Available Cash will be used to make the distributions in the priority specified in such Sections.

4.4 Payment of Distributions if Shortfall Loans Outstanding. If a Shortfall Loan is outstanding, any distribution made pursuant to Section 4.3 to which the Non-Contributing Member otherwise would be entitled will be considered a distribution to the Non-Contributing Member. The distribution, however, will be paid directly to the Other Member if the other Member has made a Shortfall Loan. Such distribution will be applied first against interest and then against principal, until all accrued interest and principal of Shortfall Loans are repaid in full. The distribution then will be applied against expenses, in the same manner as provided in Section 3.3(c) (Other Borrowings). If there are two or more Shortfall Loans outstanding to the Non-Contributing Member, any distribution paid pursuant to this Secample, where the joint venture entity in partnership form is expected to have substantial operating losses in its early years, the partners may allocate a disproportionate share of the losses to participants who have income against which to offset such losses, while allocating a disproportionate share of any other benefits or net income in future years to the other participants. The provisions of a venture's governing documents are typically structured in such a manner as to maximize all available financial benefits, whether they be in the form of income, gains, losses, deductions, tax credits, or other items.

E. Governance and Management

The venture's governing documents (whether in the form of a shareholders agreement, partnership or LLC agreement or otherwise) usually specify the mechanics of the overall governance and the day-to-day management of the venture's affairs.[28] Typically, this will in-

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tion will be applied to such Shortfall Loans on a first-in, first-out basis. If the Company has borrowed money under Section 3.3(c) (Other Borrowings), the Non-Contributing Member's distribution will be used to pay principal and interest on such loans.

4.5 No Priority. Except as otherwise provided in this Agreement, no Member will have priority over any other Member as to the return of capital, allocation of income or losses, or any distribution.

4.6 Other Distribution Rules. No Member will have the right to demand and receive property other than cash in payment for its share of any distribution. Distribution of non-cash property may be made with the consent of both Members. The preceding sentence expressly overrides the contrary provisions of DLLCA § 18–605 as to non-cash distributions.

4.7 Liquidating Distribution Provisions. Subject to Section 4.4 (Payment of Distributions of Shortfall Loans Outstanding), distributions made upon liquidation of any Member Interest will be made in accordance with the positive Book Capital Account balance of the Member. These balances will be determined after taking into account all Book Capital Account adjustments for the Company's Fiscal Year during which the liquidation occurs.

4.8 Distribution Policy. The Members recognize the need for the Company to fund its own growth. Accordingly, funds of the Company will be retained for this purpose, and no distribution under Sections 4.3(d) (Balance) or 4.3(e) (Other Available Cash) will be paid to the Members, until and so long as the Company's Cash Flow from Operations net of reserves established pursuant to Section 4.3(b) (Reserves) exceeds the level required to be self-sustaining, without the need for further investment by the Members.

4.9 Limitation upon Distributions. No distribution will be made to Members if prohibited by DLLCA § 18–607 or other Applicable Law.

[28] *Id.* at 71-83. Sections 5.1 – 5.5 of the ABA Model Joint Venture Agreement provide for the governance of the LLC as follows:

5.1 Management Committee.

(a) *Managers*. The business and affairs of the Company will be managed exclusively by or under the direction of a committee (the ''Management Committee'') consisting of four individuals (each a ''Manager''). Except for the right to appoint a delegate in Section 5.2(f) (Delegation) and for the delegation of authority to Officers provided in Section 5.7 (Other Officers and Employees), no Manager may delegate his rights and powers to manage and control the business and affairs of the Company. The foregoing expressly override the contrary provisions of DLLCA § 18–407.

(b) *Initial Appointment; Replacement*. Each Member will appoint two Managers, unless otherwise provided by Section 8.3(c) (Management Changes). The initial appointments by each Member are as follows:

Large MemberSmall Member

By written notice to the other Member and Managers, a Member may in its sole discretion remove and replace with or without cause either or both of its appointed Managers with other individuals. A Manager may be an officer or employee of a Member or of an Affiliate of a Member. Each Manager will serve on the Management Committee until his successor is appointed or until his earlier death, resignation or removal.

(c) *Compensation and Expenses of Managers*. Each Member will pay the compensation and expenses of the

Managers it appoints.

(d) *Right to Rely on Manager Certificate*. Any Person dealing with the Company may rely (without duty of further inquiry) upon a certificate signed by any Manager as to (i) the identity of any Manager or Member, (ii) the existence or nonexistence of any fact or facts that constitute a condition precedent to acts by the Management Committee or that are in any other manner germane to the affairs of the Company, (iii) the Persons who are authorized to execute and deliver any instrument or document of the Company, or (iv) any act or failure to act by the Company or any other matter whatsoever involving the Company, any Manager or any Member.

(e) *Signing on Behalf of the Company*.

(i) *Generally*. Except as otherwise provided in Section 5.1(e)(ii) or as required by law but without limiting Section 5.6(c)(v) (CEO-Authority), the signature of any Manager (or other individual to whom the Management Committee has delegated appropriate authority) is sufficient to constitute execution of a document on behalf of the Company. A copy or extract of this Agreement may be shown to the relevant parties in order to confirm such authority.

(ii) *Deeds, Certain Promissory Notes, etc*. The signature of the Chair of the Management Committee is required (A) to convey title to real property owned by the Company or (B) to execute (1) promissory notes with respect to indebtedness for borrowed money in excess of $________ and related trust deeds, mortgages and other security instruments and (2) any other document the subject matter of which exceeds $_______ or that binds the Company for a period exceeding one year.

(f) *No Authority of Members to Act on Behalf of the Company*. Except as otherwise specifically provided in this Agreement, no Member will act for, deal on behalf of, or bind the Company in any way other than through its representatives (acting as such) on the Management Committee.

5.2 Management Committee Meetings.

(a) *Meetings*. The Management Committee will hold regular meetings (at least quarterly) at such time and place as it determines. Any Manager or the Chair may call a special meeting of the Management Committee by giving the notice specified in Section 5.2(g).

(b) *Chair*. The chairperson of the Management Committee (''Chair'') will be one of the two Managers who are appointed by Large Member. The initial Chair is____________. The Chair will preside at all meetings of the Management Committee.

(c) *Participation*. Managers may participate in a meeting of the Management Committee by conference video or telephone or similar communications equipment by means of which all persons participating in the meeting can hear each other. Such participation will constitute presence in person at the meeting.

(d) *Written Consent*. Any action required or permitted to be taken at any meeting of the Management Committee may be taken without a meeting upon the written consent of the number and identity of Managers otherwise required to approve such matter at a Management Committee meeting. Each Manager will be given a copy of the written consent promptly after the last required signature is obtained. A copy of the consent will be filed with the minutes of Management Committee meetings.

(e) *Minutes*. The Management Committee will keep written minutes of all of its meetings. Copies of the minutes will be provided to each Manager.

(f) *Delegation*. Each Manager has the right to appoint, by written notice to the other Managers, any individual as his delegate. That delegate may attend meetings of the Management Committee on his behalf and exercise all of such Manager's authority for all purposes until the appointment is revoked.

(g) *Notice*. Written notice of each special meeting of the Management Committee will be given to each Manager at least five Business Days before the meeting and will identify the items of business to be conducted at the meeting. No business other than those items listed in the notice may be conducted at the special meeting, unless otherwise expressly agreed by all the Managers. The notice provisions of this Section may be waived in writing and will be waived by a Manager's attendance at the meeting, unless the Manager at the beginning of the meeting or promptly upon his arrival objects to holding the meeting or transacting business at the meeting and does not thereafter vote for or assent to action taken at the meeting.

5.3 Voting of Managers; Quorum.

(a) *Generally*. Each Manager will have one vote, subject to Section 5.3(b). Except as otherwise provided in Section 5.4, all actions by the Management Committee will require the approval of a majority of the Managers present at a meeting at which a quorum exists.

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volve a board of directors or managers of the joint venture entity on which each of the participants may have representation more or less proportional to its percentage interest in the joint

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(b) *Chair's Additional Vote*. If (i) Large Member is not a Defaulting Member (see Section 8.2) and (ii) there is a tie vote of the Managers on an action other than those described in Section 5.4, then the Chair will have an additional vote on such action.

(c) *Quorum*. Three Managers will constitute a quorum for the transaction of business, unless (i) a duly called meeting is adjourned because (A) neither of the Managers appointed by a Member attends that meeting and (B) neither of the Managers appointed by that Member attends a meeting duly called as to the same items of business of the adjourned meeting within thirty days after the adjournment of that first meeting and (ii) notice of both meetings complied with Section 5.2(g). In such event, two Members will constitute a quorum for the transaction of business.

5.4 Actions Requiring Management Committee Approval—Major.

The following actions require the approval of both (1) a majority of the Managers present at a meeting at which a quorum exists and otherwise in accordance with Section 5.3 and (2) at least one Manager appointed by each Member:

(a) amendment of this Agreement;

(b) admission of additional Members;

(c) approval of any new Business Plan or material modification of an existing Business Plan (for this purpose, any change by 10% or more during any Fiscal Year of any line item in the budget that is included in the Business Plan, any change in a Critical Target and any Additional Capital Contribution will be considered material);

(d) merger or combination of the Company with or into another Person;

(e) sale or other disposition of all or substantially all of the Company's assets;

(f) any material change in the Business, in particular, entering into the manufacture and/or sale of a new line of products or adopting a new line of business or a new business location;

(g) any material change in accounting or tax policies of the Company;

(h) conversion of the Company to another form of legal entity;

(i) entering into or amending the terms of any transaction or series of transactions between the Company and any Member, any Affiliate of a Member, or any Manager or Affiliate of a Manager; and

(j) amendment of any Related Agreement.

5.5 Actions Requiring Management Committee Approval—Other. The following actions require the approval of (1) a majority of the Managers present at a meeting at which a quorum exists and otherwise in accordance with Section 5.3 (Voting of Managers; Quorum) **but** (2) not the separate approval of at least one Manager appointed by each Member:

(a) any change in the Company's auditors (if the new auditor will be an independent, nationally recognized accounting firm);

(b) any change by less than 10% during any Fiscal Year of any line item in the budget that is included in the Business Plan or any other change in the Business Plan that does not require approval under Section 5.4(c);

(c) any establishment of reserves under Section 4.3(b) (Reserves) and other applicable provisions of this Agreement;

(d) the incurring of indebtedness for borrowed money in excess of $_____;

(e) the entering into of contracts, or series of related contracts, obligating the Company in excess of $_____;

(f) the acquisition or disposition of any interest in any other business or the participation in any increase or reduction of capital of any other business that is within the budget and consistent with the Business Plan;

(g) the purchase of real estate or other fixed assets or the sale and disposition of real estate or other fixed assets at a price of or valued at more than $_____;

(h) the lending or advancing of any monies, including the guaranteeing or indemnifying of any indebtedness, liability or obligation of any Person other than the granting of trade credit and other than in the Ordinary Course of Business as established in the then-current budget; and

(i) the creation of, the permitting to exist for more than 15 days of, or the assumption of any Encumbrance upon Company assets that have an aggregate value in excess of 10% of the aggregate value of the Company's total assets; *provided, however,* that the renewal of existing Encumbrances is not included in this limitation.

venture. Sometimes, provision is made for an independent member of the board, appointed by the agreement of the participants, in order to protect against board deadlock over operational issues.[29]

Additionally, it is common to provide that certain key decisions may be made only with the unanimous, or a supermajority, approval of the board or the members. Such key decisions often include the following matters (often with materiality parameters): (1) capital expenditures in excess of specified amounts; (2) incurring indebtedness; (3) initiating or settling litigation; (4) entering into contracts involving more than an agreed sum; or (5) entering into contracts with a joint venture participant or any of its affiliates.

The venture's governing documents typically specify the types of officers and other managers who will conduct the day-to-day operations of the venture. Provision is also typically made for the removal and replacement, compensation and other benefits, and indemnification of board members, officers and other managers.

F. Restrictions on Transfer of Joint Venture Interests

Joint ventures are entered into between a limited number of parties (typically two) who respect each other and believe the others can contribute substance and funding to the venture over an extended period. As a result, provision is typically made to restrict the participants' transfer of their joint venture interests and for the admission and withdrawal of participants to the joint venture. Typically, a participant's ability to transfer its interest is restricted to transfers to wholly-owned subsidiaries (and perhaps other affiliates) and then only so long as the transfer causes no adverse tax consequences to the joint venture or any of the other participants. A transfer of an interest to a third party can make the other parties wish to dissolve the venture or at least have the right to approve their new partner, and ordinarily are more restricted. Sometimes such transfers are entirely prohibited, although such a provision may make it necessary for the participants to have the right to unwind the venture unilaterally. Alternatively, transfers to third parties may be permitted only where the other participants have a right of first refusal to buy the interest to be transferred. A right of first refusal may apply either from the inception of the venture or after a specified number of years during which no third-party transfers are permitted. To facilitate the right of first refusal mechanism, it may be helpful to require third-party transfers to be solely for cash consideration and separate and apart from transfers of other property. The ability to make transfers to third parties is also frequently limited by the establishment of specific objective criteria which a party must satisfy in order to qualify as an acceptable transferee. These criteria might include a required minimum net worth for a transferee, a requirement that the transferee not be a competitor of the non-transferring venturer, a requirement that the transferee not be owned or controlled by foreign persons (particularly if the venture has government contracts), or any number of other matters.)

When preparing transfer restriction provisions, indirect transfers by a change in control of a participant should be considered. A change in control may be defined to include (i) a transfer of stock in a venturer by its ultimate parent entity, (ii) a change in management in the venturer in which specified individuals cease to be in control or (iii) a change in control of an ultimate parent entity.

[29] *See* Stephen Glover, et al., *Recent Trends in Joint Venture Governance*, 26 INSIGHTS 2 (Feb. 2012).

G. Defaults

Joint venture agreements often specify the events constituting an event of default by a venture participant and the remedies of the other participants upon a default.[30] The partici-

[30] *Id.* at 111-25. Article 8 of the ABA Model Joint Venture Agreement defines and establishes remedial processes for defaults by venturers as follows:

Article 8: Dissolution and Other Rights Upon Default

8.1 Applicability. This Article applies only if (a) only one Member is a Defaulting Member, in which case the Non-Defaulting Member may elect to terminate the Company in accordance with Section 8.3 (Remedies Upon Default by One Member), or (b) both Members are Defaulting Members, in which case Section 8.4 (Remedies if Both Members are Defaulting Members) will apply.

8.2 Definitions—Defaulting Member and Non-Defaulting Member and Default Event. ''Defaulting Member'' is a Member with respect to which any Default Event has occurred. A ''Non-Defaulting Member'' is a Member with respect to which no Default Event has occurred. Each of the following is a ''Default Event'':

(a) *Material Default*. Any material default by the Member in the performance of any covenant in this Agreement or in the performance of any material provision of any Related Agreement, which default continues for a period of 30 days after written notice thereof has been given by the Non-Defaulting Member to the Defaulting Member. A ''material default'' under this Section includes (i) any failure to make when due an Additional Capital Contribution or to make a required Member Loan in accordance with Section 3.2 (Additional Capital Contributions and Member Loans), (ii) any failure to make any payment when due under a Member Loan (See Section 3.2(c)—The Member Loans), (iii) any failure to make any payment when due under a Shortfall Loan (See Section 3.3(b)—Loan by Other Member) and (iv) a Critical Target Failure that is the result of a breach by a Member.

(b) *Material Breach*. A breach of any representation or warranty contained in Sections ____, ____ and ____ of Attachments 2.4-A or -B, any breach of which will be deemed to be a material breach for purposes of this Agreement.

(c) *Termination of Existence by a Member*. A Member commences any proceeding to wind up, dissolve or otherwise terminate its legal existence.

(d) *Termination of Existence by another Person*. Any Proceeding commenced against a Member that seeks or requires the winding up, dissolution or other termination of its legal existence; except if the Member defends or contests that Proceeding in good faith within 15 days of its commencement and obtains a stay of that Proceeding within 90 days of its commencement, a Default Event will not exist so long as the stay continues and the Member pursues the defense or contest diligently thereafter or the Proceeding is dismissed.

(e) *Dissociation*. The Member dissociates from the Company in violation of the prohibition against withdrawal in Section 2.3 (Term).

(f) *Prohibited Transfer*. The Member agrees to any transaction that would, if consummated, breach or result in a default under Section 6.1 (Restrictions on Transfer of Member Interests).

(g) *Change of Control*. There is a Change of Control of the Member or Person directly or indirectly controlling the Member, including a transfer pursuant to Section 6.2 (Assignment to Controlled Persons) (each a ''Target''). A ''Change of Control'' occurs when any of the following occurs:

(i) *Change in Ownership*. Any Person or group of Persons acting in concert acquires or agrees to acquire, directly or indirectly, either (A) that percent of the ownership interests of the Target that will provide the acquirer with a sufficient number of the Target's ownership interests having general voting rights to elect a majority of the directors or corresponding governing body or (B) in the case of a Target that has a class of securities registered under section 12 of the Securities Exchange Act of 1934, as amended, or that is subject to the periodic reporting requirements of that act by virtue of section 15(d) of that act, more than 30% of the Target's ownership interests having general voting rights for the election of directors or corresponding governing body.

(ii) *Board Approval of Acquisition*. The Target's board of directors or corresponding governing body recommends approval of a tender offer for 50% or more of the outstanding ownership interest of the Target.

(h) *Insolvency Proceeding*. If any of the following occurs: (i) the Member seeks relief in any Proceeding relating to bankruptcy, reorganization, insolvency, liquidation, receivership, dissolution, winding-up or relief of debtors (an ''Insolvency Proceeding''); (ii) the institution against the Member of an involuntary Insolvency Proceeding; *provided,* *however,* that if the Member defends or contests that Insolvency Proceeding in good faith within 15 days of its commencement and obtains a stay of that Proceeding within 90 days of its commencement, a Default Event will not exist so long as the stay continues and the Member pursues the defense or contest diligently thereafter or the Proceeding is dismissed; (iii) the Member admits the material allegations of a petition against the Member in any Insolvency Proceeding; or (iv) an order for relief (or similar order under non-U.S. law) is issued in any Insolvency Proceeding.

(i) *Appointment of a Receiver or Levy*. Either (i) a Proceeding has been commenced to appoint a receiver, receiver-manager, trustee, custodian or the like for all or a substantial part of the business or assets of the Member or (ii) any writ, judgment, warrant of attachment, warrant of execution, distress warrant, charging order or other similar process (each, a ''Levy'') of any court is made or attaches to the Member's Member Interest or a substantial part of the Member's properties; *provided, however,* that if the Member defends or contests that Proceeding or Levy in good faith within 15 days of its commencement and obtains a stay of that Proceeding or Levy within 90 days of its commencement, a Default Event will not exist so long as the stay continues and it pursues the defense or contest diligently thereafter or the Proceeding is dismissed.

(j) *Assignment for Benefit of Creditors*. The Member makes a general assignment for the benefit of creditors, composition, marshalling of assets for creditors or other, similar arrangement in respect of the Member's creditors generally or any substantial portion of those creditors.

8.3 Remedies—Upon Default by One Member.

(a) *By Non-Defaulting Member*. A Non-Defaulting Member may, within 90 days of becoming aware of the occurrence of a Default Event, give notice of the Default Event (a ''Default Notice'') to the Defaulting Member. The Default Notice must specify one of the following remedies (which, together with Section 8.3(c) and subject to Section 8.3(b), are exclusive remedies):

(i) *Dissolution*. Dissolution of the Company in accordance with Article 9 (Dissolution Procedures).

(ii) *Right to Buy*. The purchase of the Defaulting Member's Member Interest for 90% of Fair Market Value and otherwise in accordance with Article 11 (Buy-Sell Upon Default). The Non-Defaulting Member must propose the Fair Market Value in the Default Notice, which must be accompanied by a deposit in immediately available funds equal to 25% of the Defaulting Member's Book Capital Account as reflected in the annual financial statements of the Company for the Fiscal Year immediately preceding the year in which the Default Notice is given.

(iii) *Right To Sell*. The sale of the Non-Defaulting Member's Member Interest to the Defaulting Member for 100% of Fair Market Value and otherwise in accordance with Article 11 (Buy-Sell upon Default). The Non-Defaulting Member must propose the Fair Market Value in the Default Notice.

(b) *Other Remedies*.

(i) *Generally*. The Non-Defaulting Member's election to dissolve the Company under Article 9 (Dissolution) will not preclude its exercise of whatever rights it may also have under Article 14 (Indemnification) or at law. However, the Non-Defaulting Member's election to purchase the Defaulting Member's Member Interest under Section 8.3(a)(ii) (Right To Buy) or to sell its Member Interest under Section 8.3(a)(iii) (Right To Sell) is the election of an exclusive remedy.

(ii) *Certain Other Rights*. Notwithstanding the foregoing, no election under Section 8.3(a) will preclude either (A) the appointment of additional Managers by Small Member under Section 8.3(c) if Small Member is the Non-Defaulting Member, (B) the recourse by either the Defaulting Member or the Non-Defaulting Member to whatever injunctive relief to which it may otherwise be entitled under this Agreement or any Related Agreement or (C) the recourse by the Non-Defaulting Member under § 2.11(b) (Actions by Company) to recover amounts owing to the Company that are not specifically taken into account in the determination of Fair Market Value.

(iii) *Legal Fees and Expenses*. The Non-Defaulting Member's legal fees and expenses will be deducted from any distribution otherwise to be made to the Defaulting Member and will be paid to the Non-Defaulting Member or, if the Non-Defaulting Member elects, will be paid by the Defaulting Member to the Non-Defaulting Member.

(c) *Management Changes*. In addition to other rights a Member may have under this Section 8.3:

(i) if Small Member is the Non-Defaulting Member and it elects in its Default Notice the remedy in Section 8.3(a)(ii) (Right To Buy), it may, by simultaneously giving notice to the Defaulting Member and each Manager, also (A) appoint that number of additional Managers that will give Small Member a majority of the members of the Management Committee, (B) cause a simple majority of the members of the Management Committee to constitute a quorum, and (C) appoint the Chair of the Management Committee. Concurrently with that appointment, the appointee of pants' obligations to each other and to the joint venture may extend beyond funding and non-competition to such things as the provision of goods, services or personnel to the venture. A default in any of these obligations may be deemed a default under the joint venture agreement.

The participants may desire to structure disincentives to default, such as liquidated damages or other penalty provisions. Moreover, it may provide the non-defaulting participants with the right to buy out the interest of a defaulting participant, or to cause the dissolution of the joint venture, in addition to any damages resulting from the default. A purchase price for a buy-out provision of this type may be a specified discount from the fair market value of the interest as determined by a pre-established formula, by agreement of the parties or through a determination by a third party.

Where the joint venture obligations of a participant are guaranteed through a parent or other affiliate guarantee, certain circumstances or events in respect of the guarantor may also be deemed a default by the participant under the joint venture agreement. For example, the bankruptcy of a participant's guarantor may be deemed a default by the participant under the joint venture agreement.

H. Dispute Resolution

The joint venture agreement may provide for any number of dispute resolution mechanisms, including litigation, arbitration or other alternative forms of dispute resolution.[31]

Large Member will cease to be the Chair. However, in all cases the consent of at least one Manager appointed by each Member will continue to be required for the matters specified in Section 5.4 (Actions Requiring Management Committee Approval—Major); or

(ii) if the Non-Defaulting Member (which may be either Small Member or Large Member) elects in its Default Notice the remedy in Section 8.3(a)(i) (Dissolution), then concurrently with that notice and thereafter until the dissolution is completed or is terminated (A) the Non-Defaulting Member or its duly appointed representative will assume all of the powers and rights of the Management Committee and (B) its actions (1) will have the same effect as if taken by unanimous vote of the members of the Management Committee before the assumption and (2) will be deemed to include the consent of one Manager appointed by each Member to the matters specified in Section 5.4 (Actions Requiring Management Committee Approval—Major).

The management changes set forth in this Section 8.3(c) shall have effect only for so long as the Non-Defaulting Member is actively pursuing the remedy it elected under Section 8.3(a).

(d) *Effect of Notice*. If the Non-Defaulting Member elects in its Default Notice the remedy in Section 8.3(a)(i) (Dissolution), it will carry out that dissolution in accordance with Article 9 (Dissolution Procedures). If the Non-Defaulting Member elects in its Default Notice either to buy under Section 8.3(a)(ii) or to sell under Section 8.3(a)(iii) (and, in the former case, makes the required deposit), the Members will complete that purchase or sale, as applicable, in accordance with Article 11 (Buy-Sell Upon Default).

8.4 Remedies if Both Members are Defaulting Members. If both Members are, or become, Defaulting Members, simultaneously or sequentially, before a sale of a Member Interest under Section 8.3(a)(ii) or Section 8.3(a)(iii) has been completed, then notwithstanding any election previously made by a Non-Defaulting Member or steps taken to further such election, then (a) the Members and the Managers will proceed as expeditiously as possible to dissolve the Company in accordance with Article 9 (Dissolution Procedures) (other than Section 9.1(b)) as though such dissolution resulted from an election pursuant to Section 8.3(a)(i), and (b) both Defaulting Members will thereafter have whatever rights and remedies available to them under Article 14 (Indemnification) and under Applicable Law.

[31] *Id.* at 89-91. Article 5.9 of the ABA Model Joint Venture Agreement establishes dispute resolution procedures for disagreements regarding modifications to the Business Plan or the failure to obtain requisite approvals for specified actions as follows:

5.9 Dispute Resolution Procedures.

(a) *Failure to Approve Actions Requiring Special Approval by Management Committee*. If the Management

Whatever the mechanism, it is frequently provided that before any participant resorts to any such mechanism the dispute must be referred to specified senior level officers or managers of each participant for resolution. It is also important to provide for continued operation of the joint venture entity during the pendency of any dispute.

I. Termination

The joint venture governing documents typically specify the events, if any, which will cause a termination of the joint venture. Some agreements include a "termination for convenience" provision, under which any participant can force a termination of the joint venture, perhaps after a set period of time such as five years.[32] The joint venture agreements often include

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Committee has disagreed regarding (i) modifications to the then-current Business Plan and the disagreement has not been resolved at least ten Business Days before the beginning of the next Fiscal Year or (ii) any other action listed in Section 5.4 (Actions Requiring Management Committee Approval—Major) when properly submitted to it for a vote (either of which, a ''Business Dispute''), then the Managers will consult and negotiate with each other in good faith to find a mutually agreeable solution. If the Managers do not reach a solution within ten Business Days from the date the disagreement occurred and the failure to reach a solution, in a Member's judgment, materially and adversely affects the Company, then that Member may give notice to the other Member initiating the procedures under this Section (a ''Dispute Notice'').

(b) *Consideration by Member Executives*. Within two Business Days after the giving of the Dispute Notice, the Business Dispute will be referred by the Managers to the senior executive of each Member to whom the respective Managers report (each a ''Member Executive'') in an attempt to reach resolution. If the Member Executives are unable to resolve the Business Dispute within ten Business Days after the date of the Dispute Notice, or such longer period as they may agree in writing, then they will refer the Business Dispute to the chief executive officer of each Member. The chief executive officers will meet, consult and negotiate with each other in good faith. If they are unable to agree within twenty Business Days of the date of the Dispute Notice, then they will adjourn such attempts for a further period of five Business Days during which no meeting will be held. On the first Business Day following such period, the chief executive officers of the Members will meet again in an effort to resolve the Business Dispute. If the chief executive officers are unable to resolve the Business Dispute within 48 hours after the time at which their last meeting occurred, then Section 7.2(b) (Unresolved Business Dispute) will apply.

[32] *Id.* at 106-25. Article 8 of the ABA Model Joint Venture Agreement defines and establishes remedial processes for defaults by venturers and is set forth in note 30, *supra*. Article 7 of the ABA Model Joint Venture Agreement defines the venturers exit rights, either by dissolution or by purchase of sale of member interests, in the absence of a default as follows:

Article 7: Dissolution or Buy-Sell—in the Absence of Default

7.1 Applicability. This Article applies only if neither Member is a Defaulting Member (as defined in Section 8.2 (Definitions—Defaulting Member and Non-Defaulting Member and Default Event).

7.2 Triggering Events—Absence of Default. Either Member may elect a remedy set forth in Section 7.3 upon the occurrence of either of the following events:

(a) *Fundamental Failure*. The Company fails to achieve a Critical Target at the time specified in the Business Plan (''Critical Target Failure'') that is not a result of a material breach by a Member and the Members fail to agree upon and implement a plan to remedy that failure within 30 days (or such longer period as may be agreed by the Members) after either Member or any Manager has given notice of the failure to the Members and to each Manager.

(b) *Unresolved Business Dispute*. The occurrence of a Business Dispute unresolved under Section 5.9(b) (Consideration by Member Executives).

7.3 Remedies—Absence of Default. A Member may, within 90 days of becoming aware of the occurrence of either of the events specified in Section 7.2, give notice of the event to the other Member. The notice must specify one of the following alternative remedies (which are exclusive remedies):

(a) *Dissolution*. Dissolution of the Company in accordance with Article 9 (Dissolution Procedures).

(b) *Mandatory Buy-Sell*. Initiation of the sale of its Member Interest or the purchase of the other Member's Member Interest by giving the notice specified in Section 10.1 (Offer to Buy or Sell).

an affirmative obligation for each participant not to take any actions that would terminate the joint venture in violation of the other provisions of the joint venture agreement.

Rather than terminating the venture by terminating its business and winding up its affairs, a provision may be included for a non-defaulting participant to purchase the interests of the other participants. One method of providing for such an alternative is a "Dutch-auction" provision under which a participant may place a value on the entire joint venture and offer to purchase the interests of the other participants for their pro-rata shares of that value. Within a specified period of time, each other participant must then elect to purchase its share of the offering participant's interest at the value established by the offering participant or, failing to make such an election, must sell its interest to the offering participant at the price offered.

J. Antitrust

HSR Filing Requirements. Pre-merger notification filings under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (***"HSR"***) are generally required if all three of the following tests are met:[33]

(1)*The Commerce Test:* If either the acquiring and acquired person[34] is "engaged in commerce or any activity affecting commerce…"[35]

(2)*The Size-of-Person Test:* (i) One person in the transaction has a net sales or total assets of at least $136.4 million in sales or total assets, **and** (ii) the other party has at least $13.6 million in sales or total assets.[36]

(3)*The Size-of Transaction Test:* As a result of the transaction, (i) the acquiring person will hold an aggregate amount of stock and assets of the acquired person valued at least $68.2 million[37], **or** (ii) the acquiring person will hold an aggregate amount of voting securities[38] and assets of the acquired person valued at more than $272.8 million.[39]

In the case of a joint venture, even though the persons contributing to the formation of the unincorporated entity and the unincorporated entity itself may, in the formation transaction, be both acquiring and acquired persons within the meaning of HSR, for the above tests, the

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If both Members give notices within that time period, the notice given first prevails.

7.4 Voluntary Buy-Sell. At any time after the third anniversary of the date of this Agreement (but not earlier), if no prior notice under Section 7.3 or Section 8.3 (Remedies—Upon Default of One Member) has rightfully been given, either Member may give a written notice to the other offering to purchase the other Member's Member Interest or sell its Member Interest to the other Member in accordance with Article 10 (Buy-Sell in Absence of Default).

[33] Clayton Act 7A, 15 U.S.C. § 18a (2006). The thresholds are adjusted each year based on the percentage change in the U.S. gross national product for the fiscal year. The most recent adjustment for 2012 appeared at 77 Reg. 4324 (Jan. 24, 2011), and was effective on February 27, 2012. For the first time in history, the thresholds were decreased in 2010.

[34] 16 C.F.R. § 801.2 (Jan. 11, 2006).

[35] 16 C.F.R. § 801.1(l) and § 801.3 (Jan. 11, 2006).

[36] 77 Reg. 4324 (Jan. 24, 2011), effective February 27, 2012, *available* at http://www.ftc.gov/os/fedreg/2012/01/120124claytonact7a.pdf.

[37] 77 Reg. 4324 (Jan. 24, 2011), effective February 27, 2012, *available* at http://www.ftc.gov/os/fedreg/2012/01/120124claytonact7a.pdf.

[38] 16 C.F.R. § 801.10 (Jan. 11, 2006).

[39] 77 Reg. 4324 (Jan. 24, 2011), effective February 27, 2012, *available* at http://www.ftc.gov/os/fedreg/2012/01/120124claytonact7a.pdf.

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contributors are deemed acquiring persons only and the joint venture is deemed the acquired person only.[40]

If an HSR filing were required, there could be a waiting period of at least 30 days before the joint venture could be consummated unless "early termination" were granted.[41]

Under current HSR rules, the formation of a "non-corporate entity" - including joint ventures - is reportable if the above tests are satisfied and a party gains "control" of the entity as a result of the transaction.[42] The HSR rules define a "non-corporate interest" as "an interest in any unincorporated entity which gives the holder the right to any profits of the entity or in the event of dissolution of that entity the right to any of its assets after payment of its debts."[43] These unincorporated entities include, but are not limited to, joint ventures, general partnerships, limited partnerships, limited liability partnerships, limited liability companies, cooperatives and business trusts. The HSR rules also provide that "control" is held by a person or entity with rights to 50% or more of the profits of the entity, or 50% or more of the assets upon the entity's dissolution.[44]

HSR Filing Fee Thresholds. The HSR filing fee thresholds, as of February 27, 2012 are as follows:[45]

Filing Fee	**Value of Transaction ($ millions)**
$45,000	More than $68.2 but less than $136.4
$125,000	$136.4 to less than $682.1
$280,000	$682.1 or more

General Antitrust Considerations. Whether or not pre-merger notification is required, the prospective joint venturers need to analyze whether the joint venture will be considered unlawful under antitrust law. While there is no clear test, a number of legal standards in the relevant case law as well as agency opinions, consent orders, guidelines and speeches are summarized in the Federal Trade Commission (***"FTC"***) and U.S. Department of Justice (***"DOJ"***) Antitrust Guidelines for Collaborations Among Competitors, available at http://www.ftc.gov/os/2000/04/ftcdojguidelines.pdf. In addition, if the joint venture is sufficiently similar to a horizontal merger, then the DOJ/FTC Horizontal Merger Guidelines, http://www.ftc.gov/bc/docs/horizmer.shtm (the ***"Guidelines"***), may apply.

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[40] 16 C.F.R. § 801.50(a) (Jan. 11, 2006).

[41] Stephen M. Axinn et al., *Acquisitions under the Hart-Scott-Rodino Antitrust Improvements Act: A Practical Analysis of the Statute & Regulations* 1-14 (New York: Law Journal Press 3d ed. 2008).

[42] 16 C.F.R. § 801.1(a)(1) (Jan. 11, 2006).

[43] 16 C.F.R. § 801.1(f)(1)(ii) (Jan. 11, 2006).

[44] 16 C.F.R. § 801.1(b) (Jan. 11, 2006).

[45] *Filing Fee Information*, FEDERAL TRADE COMMISSION, http://www.ftc.gov/bc/hsr/filing2.shtm (last visited March 27, 2012).

K. Intellectual Property

Under federal law, intellectual property rights are not assignable, even indirectly as part of a business combination transaction among affiliated parties, unless the owner has agreed otherwise. This presumption of non-assignability is based on the concept that allowing free assignability would undermine the reward for invention. Where patent or copyright licenses constitute material assets to be contributed to a joint venture, the due diligence review should take into consideration not only the language of the license agreements, but also the federal law presumption against assignability of patent or copyright licenses.

In *Cincom Systems, Inc. v. Novelis Corp.*,[46] the U.S. Court of Appeals for the Sixth Circuit held that an internal forward merger between sibling entities constitutes an impermissible software license transfer, notwithstanding a state corporation statute that provides that a merger vests title to assets in the surviving corporation without any transfer having occurred.[47] The reasoning in the *Cincom* case follows that of *PPG Industries, Inc. v. Guardian Industries Corp.*,[48] which held that, although state law provided for the automatic transfer and vesting of licenses in the successor corporation in a merger without any transfer having occurred, an intellectual property license, based on applicable federal law, is presumed to be non-assignable and nontransferable in the absence of express provisions to the contrary in the license. *PPG* held the state merger statute was preempted and trumped by this federal law presumption of non-transferability.[49]

L. Confidentiality Agreement

A confidentiality agreement is the first stage for the due diligence process as parties generally are reluctant to provide confidential information to the other side without having the protection of a confidentiality agreement.[50] Confidentiality agreements in respect of joint ventures often are bilateral and provide that neither party, or any affiliate or associate of either of them, will use any of the information provided by the other for any purpose other than evalua-

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[46] Cincom Systems, Inc. v. Novelis Corp., 581 F.3d 431 (6th Cir. 2009).

[47] *Id.* at 437. The *Cincom* case involved Cincom's non-exclusive license of software to Alcan Rolled Products Division ("Alcan Ohio"), a corporation wholly owned by Alcan, Inc. The license agreement required Alcan Ohio, as licensee, to obtain Cincom's written approval prior to any transfer of its rights or obligations under the agreement. As part of an internal corporate restructuring, Alcan Ohio eventually merged into Novelis Corp., another subsidiary of Alcan, Inc. This forward merger caused the software to be owned by a different entity, but it remained on the same computer specified by the license agreement and its use of the software by the surviving entity was unchanged. Cincom was not asked to, and did not, consent to the merger. *Id.* at 434.

In addition to showing that the operation of the software was unaffected, Novelis Corp. claimed the intent of the license agreement demonstrated no concern with preventing internal corporate reorganizations. Further, Novelis Corp. argued that Ohio substantive corporate law required the court to find no transfer occurred as a result of the internal merger. *Id.* at 435.

After considering these arguments, the Sixth Circuit found that the merger was a transfer in breach of the express terms of Cincom's license and held that software licenses did not vest with the surviving entity formed as part of a corporate restructuring. The court reached this conclusion notwithstanding Ohio's merger law that automatically vests assets with the surviving entity. Relying instead on federal common law, the court aligned itself with the presumption that, in the context of intellectual property, a license is non-transferable unless there is an express provision to the contrary. *Id.* at 439-40.

[48] PPG Industries, Inc. v. Guardian Industries Corp., 597 F.2d 1090 (6th Cir. 1979).

[49] *Id.*

[50] Bryon F. Egan, *Asset Acquisitions: Assuming and Avoiding Liabilities*, 116 PENN. ST. L. REV. 913, 930 (2012) ("Asset Acquisitions").

tion of the proposed joint venture. A confidentiality agreement may also include a standstill clause that provides that neither party will acquire any securities or other interest in the other without the prior consent of the other.[51]

M. Letter of Intent

In some transactions, the parties do not sign a binding agreement until the closing. If a letter of intent has been executed that includes a no-shop provision and gives the buyer adequate opportunity to conduct due diligence, the buyer may resist becoming contractually bound until it is ready to close.[52] Conversely, the seller has an interest in not permitting extensive due diligence until the buyer is contractually bound. This is especially so in circumstances in which the buyer is a competitor or in which the seller is concerned that the due diligence process will necessitate or risk disclosure to employees, customers or competitors that the business is for sale.

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[51] In the context of discussing a joint venture between Anheuser-Busch and InBev for the distribution of InBev beer brands in the U.S. and how InBev had used knowledge of Anheuser-Busch to set the stage for its later takeover of Anheuser-Busch, the author commented:

> Many joint venture agreements include a "standstill" clause that prevents partners from buying up shares in each other, attacking each other's boards of directors, or making other moves that could be viewed as steps toward an unsolicited takeover attempt. [August Busch] The Third had opposed the idea of a deal that did not legally protect Anheuser's independence, and it would have been perfectly reasonable for Anheuser-Busch to force InBev to agree to a standstill. That never happened, though. By the time the companies' third round of talks got underway in 2006, demanding a standstill provision to ward against a takeover wasn't a major concern for [August Busch] The Fourth.
>
> In his defense, the joint venture was too small in scope to warrant a standstill agreement as a normal course of action. "I'm sure A-B could have raised it," said one company advisor. "I do think that would have been an interesting thing to bring up. But it also would probably have been outsized, relative to the scope of what that JV was."
>
> "If A-B continued along the path they were on and InBev continued on the path they were on, I don't know if a standstill would have mattered at some point," the advisor added. "Public pressure (to merge the companies) might have been fairly significant nonetheless. But that said, a standstill is a standstill, and it would certainly have been helpful in a raid defense."

Julie MacIntosh, *Dethroning the King: The Hostile Takeover of Anheuser-Busch, an American Icon* 144 (John Wiley & Sons, Inc. 1st ed. 2010).

[52] *See* Global Asset Capital, LLC vs. Rubicon US REIT, Inc., C.A. No. 5071-VCL (Del. Ch. Nov. 16, 2009), in which in the context of explaining why he granted a temporary restraining order enjoining the target and its affiliates from disclosing any of the contents of a letter of intent or soliciting or entertaining any third-party offers for the duration of the letter of intent, Delaware Vice Chancellor Laster wrote:

> [I]f parties want to enter into nonbinding letters of intent, that's fine. They can readily do that by expressly saying that the letter of intent is nonbinding, that by providing that, it will be subject in all respects to future documentation, issues that, at least at this stage, I don't believe are here. I think this letter of intent is binding . . . [A] no-shop provision, exclusivity provision, in a letter of intent is something that is important. . . . [A]n exclusivity provision or a no-shop provision is a unique right that needs to be protected and is not something that is readily remedied after the fact by money damages. . . . [C]ontracts, in my view, do not have inherent fiduciary outs. People bargain for fiduciary outs because, as our Supreme Court taught in Van Gorkom, if you do not get a fiduciary out, you put yourself in a position where you are potentially exposed to contract damages and contract remedies at the same time you may potentially be exposed to other claims. Therefore, it is prudent to put in a fiduciary out, because otherwise, you put yourself in an untenable position. That doesn't mean that contracts are options where boards are concerned. Quite the contrary. And the fact that equity will enjoin certain contractual provisions that have been entered into in breach of fiduciary duty does not give someone carte blanche to walk as a fiduciary. . . . I don't regard fiduciary outs as inherent in every agreement."

But see Paramount Comm. Inc. v. QVC Network Inc., 637 A.2d 34, 51 (Del. 1994) (noting that a board cannot "contract away" its fiduciary duties); *see also* ACE Ltd. v. Capital Re Corp., 747 A. 2d 95, 107-08 (Del. Ch. 1999).

III. TRANSFERRING ASSETS TO A JOINT VENTURE

A. Overview

Transferring assets to a joint venture, including a division or a subsidiary, revolves around a purchase agreement between the buyer (the joint venture) and the selling entity (one of the joint venture parties) and sometimes its owners.[53] Purchases of assets are characterized by the acquisition by the buyer of specified assets from an entity, which may or may not represent all or substantially all of its assets, and the assumption by the buyer of specified liabilities of the seller, which typically do not represent all of the liabilities of the seller. When the parties choose to structure an acquisition as an asset purchase, there are unique drafting and negotiating issues regarding the specification of which assets and liabilities are transferred to the buyer, as well as the representations, closing conditions, indemnification and other provisions essential to memorializing the bargain reached by the parties. There are also statutory (e.g., bulk sales and fraudulent transfer statutes) and common law issues (e.g., de facto merger and other successor liability theories) unique to asset purchase transactions that could result in an asset purchaser being held liable for liabilities of the seller which it did not agree to assume.[54]

A number of things can happen during the period between the signing of a purchase agreement and the closing of the transaction that can cause a buyer to have second thoughts about the transaction. For example, the buyer might discover material misstatements or omissions in the seller's representations and warranties, or events might occur, such as the filing of litigation or an assessment of taxes, that could result in a material liability or, at the very least, additional costs that had not been anticipated. There may also be developments that could seriously affect the future prospects of the business to be purchased, such as a significant downturn in its revenues or earnings or the adoption of governmental regulations that could adversely impact the entire industry in which the target operates.

The buyer initially will need to assess the potential impact of any such misstatement, omission or event. If a potential problem can be quantified, the analysis will be somewhat easier. However, the impact in many situations will not be susceptible to quantification, making it difficult to determine materiality and to assess the extent of the buyer's exposure. Whatever the source of the matter, the buyer may want to terminate the acquisition agreement or, alternatively, to close the transaction and seek recovery from the seller. If the buyer wants to terminate the agreement, how strong is its legal position and how great is the risk that the seller will dispute termination and commence a proceeding to seek damages or compel the buyer to proceed with the acquisition? If the buyer wants to close, could it be held responsible for the problem and, if so, what is the likelihood of recovering any resulting damage or loss against the seller? Will closing the transaction with knowledge of the misstatement, omission or event have any bearing on the likelihood of recovering?

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[53] For a detailed discussion of asset purchase transactions, *see* Asset Acquisitions, *supra* note 50.

[54] These drafting and legal issues are dealt with from a United States (***"U.S."***) law perspective in the *Model Asset Purchase Agreement with Commentary*, which was published by the Negotiated Acquisitions Committee of the American Bar Association (*"ABA"*) in 2001 (the *"Model Asset Purchase Agreement"* or the *"Model Agreement"*). In recognition of how mergers and acquisitions (*"M&A"*) have become increasingly global, the Model Agreement was accompanied by a separate ABA Negotiated Acquisitions Committee volume in 2001 entitled *International Asset Acquisitions*, which included summaries of the laws of 33 other countries relevant to asset acquisitions, and in 2007 was followed by another ABA Negotiated Acquisitions Committee book, which was entitled *International Mergers and Acquisitions Due Diligence* and which surveyed relevant laws from 39 countries.

The dilemma facing a buyer under these circumstances seems to be occurring more often in recent years. This is highlighted by the Delaware Chancery Court decisions in *IBP, Inc. v. Tyson Foods, Inc.*,[55] in which the Court ruled that the buyer did not have a valid basis to terminate the merger agreement and ordered that the merger be consummated, and *Frontier Oil Corp. v. Holly Corp.*,[56] in which the Court ruled a target had not repudiated a merger agreement by seeking to restructure the transaction due to legal proceedings commenced against the buyer after the merger agreement was signed. While these cases are each somewhat unique and involved mergers of publicly-held corporations, the same considerations will generally apply to acquisitions of closely-held businesses.[57] In the event that a buyer wrongfully terminates the purchase agreement or refuses to close, the buyer could be liable for damages under common law for breach of contract.[58] There is little case law dealing with these issues in the context of an asset transfer to a joint venture because, more often than not, the parties will attempt to reach a settlement rather than resorting to legal proceedings.

The issues to be dealt with by the parties to an asset transfer to a joint venture will depend somewhat on the structure of the transaction and the wording of the acquisition agreement. Regardless of the wording of the agreement, however, there are some situations in which a buyer can become responsible for a seller's liabilities under successor liability doctrines. The analysis of these issues is somewhat more complicated in the acquisition of assets, whether it be the acquisition of a division or the purchase of all the assets of a seller.

B. Alternative Structures for Transfers of Businesses to Joint Venture

The actual form of the sale of a business can involve many variations. Nonetheless, there are many common threads involved for the draftsman. The principal segments of a typical agreement for the sale of a business include:

- Introductory material (i.e., opening paragraph and recitals);
- The price and mechanics of the business combination;
- Representations and warranties of the buyer and seller;
- Covenants of the buyer and seller;
- Conditions to closing;
- Indemnification;
- Termination procedures and remedies; and

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[55] IBP, Inc. v. Tyson Foods, Inc. (*In re* IBP, Inc. S'holders Litig.), 789 A.2d 14 (Del. Ch. 2001).

[56] CA No. 20502, 2005 WL 1039027, (Del. Ch. Apr. 29, 2005).

[57] Nixon v. Blackwell, 626 A.2d 1366, 1380-81 (Del. 1993) (en banc) (refusing to create special fiduciary duty rules applicable in closely held corporations); s*ee* Merner v. Merner, 129 F. App'x 342, 343 (9th Cir. 2005) (California would follow approach of Delaware in declining to make special fiduciary duty rules for closely held corporations); *but see* Donahue v. Rodd Electrotype Co., 367 Mass. 578, 328 N.E.2d 505, 515 & n. 17 (Mass. 1975) (comparing a close corporation to a partnership and holding that "stockholders in the close corporation owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another").

[58] *See* Rus, Inc. v. Bay Industries, Inc. and SAC, Inc., No. 01 Civ. 6133 (GEL), 2004 WL 1240578 (S.D.N.Y. May 25, 2004), discussed in the Comment to Section 11.4 of the Model Agreement *infra*.

- Miscellaneous (boilerplate) clauses.

There are many basic legal and business considerations for the draftsman involved in the preparation of agreements for the sale of a business. These include federal income taxes; state sales, use and transfer taxes; federal and state environmental laws; federal and state securities laws; the accounting treatment; state takeover laws; problems involving minority shareholders; the purchaser's liability for the seller's debts and contingent liabilities; insolvency and creditors' rights laws; problems in transferring assets (mechanical and otherwise); state corporation laws; stock exchange rules; pension, profit-sharing and other employee benefit plans; antitrust laws; foreign laws; employment, consulting and non-compete agreements; union contacts and other labor considerations; the purchaser's security for breach of representations and warranties; insurance; and a myriad of other considerations.[59]

There are three basic forms of business acquisitions:

(i) Statutory business combinations (e.g., mergers, consolidations and share exchanges);

(ii) Purchases of shares; and

(iii) Purchases of assets.

C. Mergers and Consolidations

Mergers and consolidations involve a vote of shareholders, resulting in the merging or disappearance of one corporate entity into or with another corporate entity. Mergers and consolidations can be structured to be taxable or non-taxable for federal income tax purposes. Simply stated, if stock is the consideration for the acquisition of the non-surviving corporation, the merger can qualify as an "A" reorganization (IRC § 368(a)(1)(A)). Thus, a shareholder of the target corporation receives stock in the purchasing corporation wholly tax-free. However, a shareholder of the target company who receives only "boot" (i.e., consideration other than purchaser's stock or other purchaser securities under certain circumstances) is normally taxed as if the shareholder had sold his stock in the target corporation in a taxable transaction. Generally stated, a shareholder who receives both stock and boot is not taxed on the stock received but is taxed on the boot. The boot is taxed either as a dividend or as a capital gain, but not in excess of the gain which would have been realized if the transaction were fully taxable.

D. Purchases of Shares

Purchases of shares of the target company can likewise be handled on a taxable or non-taxable basis. In a voluntary stock purchase, the acquiring corporation must generally negotiate with each selling shareholder individually. An exception to this is a mechanism known as the "share exchange" permitted by certain state business corporation statutes[60] under which the vote of holders of the requisite percentage (but less than all) of shares can bind all of the shareholders to exchange their shares pursuant to the plan of exchange approved by such vote.

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[59] *See* Byron F. Egan, *The Roles of an M&A Lawyer*, INSIDE THE MINDS: STRUCTURING M&A TRANSACTIONS (2007); George W. Dent, Jr., *Business Lawyers as Enterprise Architects*, 64 BUS. LAW. 279 (Feb. 2009).

[60] *See, e.g.* TEX. BUS. ORG. CODE ANN. §§ 10.051, 10.053, 10.054, 10.056 (Vernon 2006), § 10.055, 21.454 (Vernon 2007), § 10.052 (Vernon 2011).

Generally speaking, if the purchasing corporation acquires the stock of the target corporation solely in exchange for the purchaser's voting stock and, after the transaction the purchasing corporation owns stock in the target corporation possessing at least 80% of the target's voting power and at least 80% of each class of the target corporation's non-voting stock, the transaction can qualify as a tax-free "B" reorganization.[61]

Note that one disadvantage of an acquisition of the target corporation's stock is that the purchasing corporation does not obtain a "step-up" in the basis of the target corporation's assets for tax purposes. If the stock acquisition qualifies as a "qualified stock purchase" under IRC §338 (which generally requires a taxable acquisition by a corporation of at least 80% of the target corporation's stock within a 12-month period), an election may be made to treat the stock acquisition as a taxable asset purchase for tax purposes. However, after the effective repeal of the *General Utilities* doctrine, discussed *infra*, IRC §338 elections are seldom made unless the target is a member of a group of corporations filing a consolidated federal income tax return (or, since 1994, an S corporation) and the seller(s) agree to an IRC §338(h)(10) election, which causes the seller to bear the tax on the deemed asset sale since the present value of the tax savings to the buyer from a stepped-up basis in target's assets is less than the corporate-level tax on the deemed asset sale.

E. Asset Purchases

Generally speaking, asset purchases feature the advantage of specifying the assets to be acquired and the liabilities to be assumed. A disadvantage involved in asset purchases in recent years, however, has been the repeal, pursuant to the Tax Reform Act of 1986, of the so-called *General Utilities* doctrine. Prior to then, the Code generally exempted a "C" corporation from corporate-level taxation (other than recapture) on the sale of its assets to a third party in connection with a complete liquidation of the corporation and the distribution of the proceeds to its shareholders. After the effective repeal of the *General Utilities* doctrine, a "C" corporation generally recognizes full gain on a sale of assets even in connection with a complete liquidation. Thus, if a purchasing corporation buys the target's assets and the target corporation liquidates, the target pays a corporate-level tax on its full gain from the sale of its assets (not merely the recaptured items). The shareholders of the target are taxed as if they had sold their stock for the liquidation proceeds (less the target's corporate tax liability). Absent available net operating losses, if the sale is a gain, the *General Utilities* doctrine repeal thus makes an asset sale less advantageous for the shareholders.

Generally speaking, for a non-taxable acquisition of assets, the purchaser must acquire "substantially all" of the target's assets <u>solely</u> in exchange for the voting stock of the purchaser. See IRC §368(a)(1)(C). Basically, a "C" reorganization is disqualified unless the target distributes the purchaser's stock, securities and other properties it receives, as well as its other properties, in pursuance of the plan of reorganization.

There are a number of other tax requirements applicable to tax-free and taxable reorganizations, too numerous to cover in this outline.

[61] *See* 26 U.S.C.A. § 368 (West 2011).

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BOILERPLATE PROVISIONS

Akash D. Sethi, Derrick Carson, and Brad L. Whitlock*

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I. INTRODUCTION

Black's Law Dictionary defines "Boilerplate" as: "Language which is used commonly in documents having the same meaning; used to describe standard language in a legal document that is identical in instruments of a like nature."[1] Boilerplate language certainly serves a purpose to reduce transaction costs and avoid protracted negotiation over what, in many instances, are standard terms. But, too often, lawyers rely on this common usage of the term "boilerplate" when examining, or rather glossing over, relatively customary contractual provisions such as recitals, statements of consideration, and the ever-dangerous miscellaneous section. Like other contractual provisions, mere reliance on form boilerplate provisions can yield unintended and often unfavorable results. Therefore, attorneys are cautioned to review these provisions with the same care as they would review the remaining terms of a given contract.

In evaluating the appropriateness of boilerplate language, attorneys should consider the following:

A. What type of agreement is involved?

The above definition makes clear that boilerplate is standard with respect to "instruments of a like nature."[2] For example, an assignment clause in an acquisition agreement will likely be significantly different than a similar provision in a credit agreement or intellectual property license. Further, different types of agreements almost certainly will have their own respective universes of boilerplate provisions, such as language in a consulting agreement regarding the status of a party as an independent contractor or in a supplier agreement where no joint venture is created, which have little to no applicability to another type of agreement.

B. Who are the parties?

Boilerplate provisions should be consistent with the identified parties and take into account how these parties will interact or implement the relevant agreement. For example, acquisition agreements and stockholder agreements often include amendments and waiver provisions that are operative when signed by a seller representative or some percentage of outstanding shares, rather than all parties.

C. What is the intended impact of other contractual provisions?

Although these provisions are "standard," they should be tailored to be consistent with the other terms of the contract. Careless review of boilerplate provisions may result in terms that conflict with or counteract heavily negotiated contractual terms, such as indemnification and remedies.

This article provides sample language for various common boilerplate provisions, along with relevant law and tips to assist practitioners in the understanding, negotiating, and drafting of these provisions. Appendix A to this article includes forms of additional boilerplate provisions not discussed herein. Appendix B includes additional sources that were influential in the preparation of these materials and which provide additional guidance for practitioners regarding various boilerplate provisions.

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[1] BLACK'S LAW DICTIONARY 198 (9th ed. 2009).

[2] *Id.*

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II. PRELIMINARY MATTERS

Every contract should contain an introductory paragraph that sets forth the exact names of the contracting parties. The identity of the parties should be clearly set forth (*i.e.*, a "Texas limited liability company" or "an individual resident of the state of Texas") and the parties should be clearly defined (*i.e.*, "Seller," "Debtor," etc.) so that they can be easily referenced throughout the contract. Further, the identification should include any limits on the purposes for which any parties are bound to the contract (*e.g.*, "solely in his capacity as seller representative" or "solely for the purpose of Sections X and Y"). The effective date of the contract should be included as well. While this may seem like an unimportant exercise, these descriptions could become very critical in the event questions arise later as to the proper parties to the contract.

A. Recitals

Recitals are not technically part of a contract unless it appears that the parties intended for them to be (or specifically made them a part of the contract).[3] However, it is a prudent practice to include recitals in a contract in order to help identify the intentions of the parties and the reasons for entering into the contract. Recitals can also be particularly helpful for explaining complex factual situations that led to the contract. Finally, a drafter should also consider whether to make the recitals an express part of the contract. It is usually prudent to do this to assure that the recitals will be admissible in interpreting the contract's substantive provisions.

B. Statement of Consideration

Every lawyer learned in his or her first year contracts class that every contract must be supported by consideration in order to be enforceable. Accordingly, contracts should contain a description or recital of the consideration being given. By including a recital, the drafter creates a presumption that the consideration contained in the contract is sufficient.[4] As a result, there will often be a statement to the following effect between the recitals and the actual operative provisions of the contract:

> NOW, THEREFORE, for good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the parties do agree as follows:

While this language does create the presumption that the contract is supported by consideration, that presumption can be rebutted. Furthermore, it does not prevent evidence that any promised consideration was never delivered. If a formal recital regarding consideration is successfully rebutted, the contract may be unenforceable for lack of consideration.[5]

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[3] *See* Universal Health Servs., Inc. v. Thompson, 63 S.W.3d 537, 543 (Tex. App.—Austin 2001, no pet.).

[4] *See* Hoagland v. Finhold, 773 S.W.2d 740, 743 (Tex. App.—Dallas 1989, no writ).

[5] *See generally* Gary Safe Co. v. A.C. Andrews Co., Inc., 568 S.W.2d 166, 168 (Tex. Civ. App.—Dallas 1978, writ ref. n.r.e.) (finding no consideration to support alleged contract).

III. DISPUTE RESOLUTION

A. Governing Law

Absent a valid choice of law provision, the law of the state with the most significant relationship will govern the enforcement of a contract.[6] The enforcement of choice-of-law provisions in commercial transactions is generally governed by Chapter 271 of the Texas Business & Commerce Code. The general rule is that the parties' choice will be enforced if their choice is in writing and bears a reasonable relation to the jurisdiction whose law is chosen.[7] If the transaction is a "qualified transaction" (*i.e.,* involves consideration in excess of one million dollars), the parties' choice will be enforced regardless of whether it bears a reasonable relation to the transaction.[8] The following is a typical choice of law provision:

> Governing Law. This Agreement shall be governed by, interpreted under, and construed and enforced in accordance with the laws of the State of Texas, without regard to conflicts of law principles.

Even where the parties elect to be governed by the law of a particular jurisdiction, there will be areas where Texas courts will apply the laws of another jurisdiction and areas that are governed by the laws of another state, such as provisions regarding the transfer of title to certain assets or properties and the voting of stock or other corporate law matters. In addition, there are instances in which Texas law limits the ability of certain parties to select foreign law, even if it bears a reasonable relation to the transaction.[9]

B. Venue and Forum

In general, parties in Texas can contractually agree to venue in a county that would otherwise be a proper venue. However, Texas law will not enforce the parties' selection if that choice contravenes the Texas venue statutes.[10] In other words, Texas law will enforce the venue selected by the parties if the parties could have brought the suit in that venue regardless of the venue selection provision. The only exception to this general rule is for "major transactions" under section 15.020 of the Texas Civil Practice & Remedies Code. In transactions involving consideration greater than one million dollars, the parties may contractually agree to venue regardless of the general venue statutes.

Venue selection, however, should not be confused with forum selection in which the parties contractually agree to both jurisdiction and venue of another state. Forum selection clauses in Texas are generally enforceable.[11] Below is a customary venue and forum selection provision:

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[6] *See, e.g.,* Duncan v. Cessna Aircraft Co., 665 S.W.2d 414, 421 (Tex. 1984).

[7] *See* TEX. BUS. & COM. CODE ANN. § 271.005(a) (West 2009).

[8] *See id.*

[9] *See, e.g.,* TEX. BUS. & COM. CODE ANN. § 272.001(b) (providing that a contractual provision selecting foreign law is voidable at the contractor's option if the project is for the construction or repair of an improvement to real property in Texas).

[10] *See* Fidelity Union Life Ins. Co. v. Evans, 477 S.W.2d 535, 537 (Tex. 1972) (refusing to enforce contractual venue selection based on public policy).

[11] *See* Sw. Intelecom, Inc. v. Hotel Networks Corp., 997 S.W.2d 322, 324 (Tex. App.—Austin 1999, pet. denied).

> Forum. Each party agrees that any suit, action or proceeding brought by such party against the other in connection with or arising from this Agreement ("Judicial Action") shall be brought against any of the parties only in any United States federal or state court located in the state of Texas and each of the parties hereto hereby consents to the exclusive jurisdiction of such courts (and of the appropriate appellate courts) in any such judicial action and waives any objection to venue laid therein. Process in any such judicial action proceeding may be served on any party anywhere in the world, whether within or without the state of Texas.

Note that this provision is particularly careful to include both state and federal courts. In this regard, a preposition can be significant with courts "of" Texas having a different meaning than courts "in" Texas.[12]

C. Arbitration

The decision of whether to include an arbitration provision should never be considered a "boilerplate" decision. But in those instances where the parties agree that arbitration is appropriate for all or certain disputes that may arise in their dealings, there are a number of elements to consider in determining whether a particular arbitration clause is appropriate. In this regard, it is worth noting that the parties have considerable flexibility in crafting the form of the arbitration that they believe is best for them. As one court has noted:

> Indeed, short of authorizing trial by battle or ordeal or, more doubtfully, by a panel of three monkeys, parties can stipulate to whatever procedures they want to govern the arbitration of their disputes; parties are as free to specify idiosyncratic terms of arbitration as any other terms in their contract.[13]

That being said, there are seven elements that should be considered in reviewing any arbitration provision:

(1) *Scope* – Is it a broad provision (*e.g.,* "any and all disputes arising out of or related to this Agreement") or a narrow one (*e.g.*, "disputes concerning pricing adjustments under Article X")?

(2) *Parties* – Is the agreement applicable just to the contracting parties or to their affiliates and third-party disputes as well? Can multiple parties to the same transaction be joined in the same arbitration? For example, this is frequently an issue in construction disputes regarding whether the owner can join both the contractor and the architect in the same proceeding.

(3) *Administration of the Arbitration* – Will the dispute be administered through an arbitral institution such as the American Arbitration Association, JAMS or the London Court of International Arbitration, or will it be handled *ad hoc* by the parties themselves? If it is *ad hoc*, what are the governing rules?

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[12] *See, e.g.,* Dixon v. TSE Int'l Inc., 330 F.3d 396, 397-98 (5th Cir. 2003) (per curium) (holding that a forum selection clause stating "The Courts of Texas, U.S.A. shall have jurisdiction …" constituted a waiver of right to federal court); Berry v. WPS, Inc., A.H.-05-2005, 2005 WL 1168412 (S.D. Tex. May 16, 2005) (providing that a provision specifying courts "in" Harris County, Texas did not constitute a waiver of federal courts).

[13] Baravati v. Josephtal, Lyon & Ross, Inc., 28 F.3d 704, 709 (7th Cir. 1994).

(4) *Arbitrator number, selection and qualification* – Will the dispute be governed by a single arbitrator, a panel of three, or possibly one or the other depending on the amount in controversy? How will the arbitrators be selected? Are there any minimal qualifications of those that will serve as arbitrator?

(5) *Place of Arbitration* – Of these elements of a good clause, this one may have the most significant legal consequence, particularly with regard to international transactions. In this regard, the place chosen should be a signatory to the 1958 Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the New York Convention). As a general proposition, fixing the place of arbitration in a country that is a signatory to the New York Convention both increases the likelihood that the award will be enforced and minimizes the likelihood that courts will interfere with the arbitration proceeding.

(6) *Language of Arbitration* – In what language will the proceedings be conducted and the award rendered?

(7) *Discovery* – Generally, arbitration rules apply a more streamlined discovery process as part of the perceived increased speed and reduced cost of arbitration, as compared to traditional litigation. However, the parties are free to specify a more robust discovery procedure or apply specific limits on depositions and the like.

*Appendix C includes various model arbitration clauses.

D. Waiver of Jury Trial

It is settled law in Texas that a party can contractually agree to waive its right to trial by jury if the waiver is knowing and voluntary.[14] A waiver of jury trial should be conspicuous.[15]

> **WAIVER OF JURY TRIAL.** NO PARTY TO THIS AGREEMENT OR ANY ASSIGNEE, SUCCESSOR, HEIR OR PERSONAL REPRESENTATIVE OF A PARTY SHALL SEEK A JURY TRIAL IN ANY LAWSUIT, PROCEEDING, COUNTERCLAIM, OR ANY OTHER LITIGATION PROCEDURE BASED UPON OR ARISING OUT OF THIS AGREEMENT OR ANY OF THE ANCILLARY AGREEMENTS OR THE DEALINGS OR THE RELATIONSHIP BETWEEN THE PARTIES. NO PARTY WILL SEEK TO CONSOLIDATE ANY SUCH ACTION, IN WHICH A JURY TRIAL HAS BEEN WAIVED, WITH ANY OTHER ACTION IN WHICH A JURY TRIAL CANNOT OR HAS NOT BEEN WAIVED. THE PROVISIONS OF THIS SECTION _____ HAVE BEEN FULLY DISCUSSED BY THE PARTIES HERETO, AND THESE PROVISIONS SHALL BE SUBJECT TO NO EXCEPTIONS. NO PARTY HERETO HAS IN ANY WAY AGREED WITH OR REPRESENTED TO ANY OTHER PARTY HERETO THAT THE PROVISIONS OF THIS SECTION _____ WILL NOT BE FULLY ENFORCED IN ALL INSTANCES.

[14] *See In re* Prudential Ins. Co. of Am., 148 S.W.3d 124, 132-33 (Tex. 2004) (concluding that public policy does not forbid a party's ability to contract away a right to a jury trial).

[15] *See id.* at 134 (noting the jury trial waiver was not concealed or in fine print); *In re* Bank of America, 278 S.W.3d 342, 345 (Tex. 2009) (recognizing that the contractual waiver of jury trial was one of five clauses in the entire real estate purchase agreement which included a bolded introductory caption and that the words waiver and trial by jury in the provision were hand-underlined).

However, one cautionary note is that not all states look upon waivers of jury trials as kindly as Texas. While New York law will generally enforce waivers, other states like California and Georgia may not.[16] For instance, California has specific constitutional limitations on when a jury trial may be waived and those provisions are fairly strictly construed by the California courts.[17]

IV. MISCELLANEOUS PROVISIONS

A. Amendments & Waivers

Most every contract includes provisions specifying the manner in which the parties may change the terms of their contractual relationship through amendments and waivers. Generally, these provisions require that amendments and waivers be accomplished in a writing signed by the parties:

> Amendment. This Agreement may be amended or modified in whole or in part at any time only by an agreement in writing among the parties.
>
> Waivers. No waiver of any term or provision of this Agreement shall be binding unless executed in writing by the party entitled to the benefit thereof.

Unless a contract is required to be in writing under the statute of frauds or other applicable law, Texas courts may enforce an oral amendment or waiver notwithstanding such contractual limitations.[18] Further a contract may be modified by course of dealing or a provision waived by the conduct of the parties.[19]

The application of amendment and waiver provisions in agreements with just two parties is fairly straightforward. However, where contracts have multiple parties such as credit agreements, stockholders agreements, and acquisition agreements, customary amendment or waiver provisions like those set forth above can result in unacceptable veto rights and increased difficulty in contract management. Therefore, amendment and waiver provisions in multiple party agreements often permit amendments and waivers to be adopted by only a subset of the parties, such as a majority of stockholders or lenders or a seller representative.

In these situations, it is important that there is a consistent standard for amendments and waivers. In addition, practitioners should ensure that clients retain approval rights over any particularly important or specifically granted rights. Although negotiations often lead to specific approval rights where they result in a "material and adverse" or "disproportionate" effect on one or more parties, such language may only have limited value based on the specific circumstances of each transaction and the contemplated amendment and may increase the like-

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[16] *See, e.g.,* Barclays Bank of N. Y. v. Heady Elec. Co., 174 A.D.2d 963, 964-65 (N.Y. App. Div. 1991) (enforcing jury waiver); Bank South, N.A. v. Howard, 444 S.E.2d 799, 800 (Ga. 1994) (refusing to enforce jury waiver).

[17] *See* CAL. CONST. art. I, § 16; *see also* Grafton Partners v. Super. Ct., 116 P.3d 479, 492 (Cal. 2005).

[18] *See* Mar-Lan Indus., Inc. v. Nelson, 635 S.W.2d 853, 855 (Tex. App.—El Paso 1982, no writ); *see also* TEX. BUS. & COM. CODE ANN. § 2.209(b) (giving effect to provisions requiring modifications in writing).

[19] *See* TEX. BUS. & COM. CODE ANN. § 2.202(1); Carpet Servs., Inc. v. George A. Fuller Co. of Tex., Inc., 802 S.W.2d 343, 346 (Tex. App.—Dallas 1990) *aff'd*, 823 S.W.2d 603 (Tex. 1992); TEX. BUS. & COM. CODE ANN. § 2.209(d) cmt. 4.

lihood of a dispute regarding whether the approval right has been triggered.

B. Notices

A contract should always include a provision that sets forth how the parties are to deliver notices to each other. This will allow the parties to avoid misunderstandings and confusion regarding how communications regarding the contract are to be sent. There are a number of methods that can be used to deliver notice under a contract. Some of the more common methods are: hand delivery, United States mail (either with or without return receipt requested), overnight courier service, telecopy (fax), or e-mail. The use of e-mails to deliver notice has become more popular in recent years, although it is admittedly difficult to confirm delivery in many cases. Therefore, using a confirmation of delivery or similar feature and also providing notice by more traditional method is advisable.

In drafting a notice provision, consideration should be given to whether notice shall be "deemed" received if specified steps are taken. Deeming notice will prevent a party from avoiding the notice (whether through a move or otherwise) and thus avoiding the consequences of that notice. A sample notice provision that deems notice to be given would read as follows:

> <u>Notice</u>. All notices and other communications required or permitted by this Agreement shall be in writing and shall be deemed given to a party when (a) delivered to the appropriate address by hand or by nationally recognized overnight courier service (costs prepaid); (b) sent by facsimile or e-mail with confirmation of transmission by the transmitting equipment, or (c) received or rejected by the addressee, if sent by certified mail, return receipt requested, in each case to the following addresses, facsimile numbers or e-mail addresses designated below (or to such other address, facsimile number or e-mail address as a party may designate by notice to the other parties):

Texas law allows parties to waive service of process.[20] As a result, drafters also may be able use a notice provision to contractually alter otherwise applicable service of process requirements by inserting language such as:

> Each party hereto agrees that service of process upon such party at the address referred to in this Section ___, together with written notice of such service to such party, shall be deemed effective service of process on such party.

C. Assignment

With limited exceptions, contracts, and the rights provided thereunder, are assignable unless prohibited by law.[21] Therefore, agreements should include any prohibition on assignment intended by the parties in a provision similar to the following:

> <u>Assignment</u>. This Agreement and the rights, duties, and obligations hereunder may not be transferred or assigned by either of the parties [, whether directly or indirectly by merger, consolidation, reorganization, dissolution, operation of law or otherwise,] without the prior written consent of the other party. Any attempted

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[20] *See, e.g.*, TEX. R. CIV. P. § 124; Werner v. Colwell, 909 S.W.2d 866, 869-70 (Tex. 1995).

[21] Crim Truck & Tractor Co. v. Navistar Int'l Transp. Corp., 823 S.W.2d 591, 596 (Tex. 1992).

> transfer or assignment without consent in violation of the foregoing shall be void. Subject to the foregoing, this Agreement and the provisions hereof shall be binding on the parties and their respective permitted successors and permitted assigns.

A merger does not constitute an assignment in Texas.[22] As a result, practitioners can further restrict assignments to include mergers and various assignments by operation of law by including the bracketed text in the above form.

Under Texas law, there is no implied covenant to act reasonably in withholding consent.[23] Consequently, it is common for parties to include a qualifier such as "such consent not to be unreasonably withheld, delayed, or conditioned."

Although Texas courts have not provided guidance on what constitutes reasonable conduct with respect to a consent to assignment, a consenting party should be able to consider: (1) the current and historical financial condition of the proposed assignee, (2) the experience and business acumen of the proposed assignee, (3) the proposed use of the assigned rights by the proposed assignee, and (4) the honesty and good-faith of the proposed assignee.[24] However, personal taste and convenience are not proper considerations, and it is unreasonable to withhold consent solely to extract an economic concession or improve economic position.[25] Accordingly, if there are certain potential assignees, such as direct competitors or "vulture" funds that may be unpalatable to either of the contracting parties, attorneys should identify them as specific exclusions in the assignment paragraph.

Similarly, there may be instances in which one or more of the parties' desires or needs to have a limited ability to assign the Agreement to third parties without the necessity of consent. Common instances include assignments to subsidiaries or affiliates, a sale of all or substantially all of a party's assets, and collateral assignment to lenders. Practitioners can include these "permitted" assignments by qualifying the consent requirement through specific language such as:

> [P]rovided, however, that either party may assign this Agreement without such consent to: (i) any of such party's subsidiaries or affiliates, in which event such party shall remain responsible for the performance of its obligations hereunder, (ii) an unrelated buyer of all or substantially all of the assets of such party, or (iii) any lender to such party or any of its subsidiaries as security for indebtedness to such lender.

D. Third Party Beneficiaries

The presumption in Texas is that parties to a contract do not intend to benefit any third party unless the agreement contains an express provision to the contrary.[26] Notwithstanding this presumption, it is common for agreements to include a provision such as the following to disclaim third party beneficiary status:

> <u>Third Party Beneficiaries</u>. This Agreement is for the sole benefit of the parties

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[22] TEX. BUS. ORGS. CODE ANN. § 10.008(a)(2)(C) (West 2008).

[23] Reynolds v. McCullough, 739 S.W.2d 424, 429 (Tex. App.—San Antonio 1987, writ denied).

[24] *See* Chapman v. Katz, 862 N.E.2d 735, 745 (Mass. 2007); Fladeboe v. Am. Isuzu Motors Inc., 58 Cal. Rptr. 3d 225, 240-41 (Cal. Ct. App. 2007).

[25] *See Chapman*, 862 N.E.2d at 745.

[26] *See* MCI Telecomm. Corp. v. Tex. Utils. Elec. Co., 995 S.W.2d 647, 651-52 (Tex. 1999).

> hereto and their respective successors and permitted assigns. Nothing herein shall give or be construed to give any person or entity, other than the parties hereto and their respective successors and permitted assigns, any legal or equitable rights hereunder.

Agreements often include various rights that are intended to benefit third parties, such as indemnification, waiver, and release provisions that run to affiliates, subsidiaries, stockholders, and other persons not subject to the agreement and provisions that are enforceable by third party lenders. In these cases, attorneys should qualify the above form to include these third party beneficiaries specifically by using language like, "[e]xcept as otherwise provided in this Agreement" or "[e]xcept for the persons entitled to indemnification under Section X and the persons entitled to benefits of the waivers under Section Y."

E. Integration

The insertion of a standard integration clause similar to the following allows parties to invoke the protection of the parol evidence rule:

> Integration. The Agreement and the agreements and documents referred to herein (including the Exhibits and Schedules hereto) contain the entire agreement and understanding of the parties hereto with respect to the subject matter hereof and supersede all prior agreements and understandings, whether written or oral, relating to the subject matter hereof. There are no other agreements [representations, or warranties] between or among the parties other than those set forth in this Agreement and the agreements and documents referred to herein.

The parol evidence rule provides that a writing intended by the parties as a final expression of their agreement may not be contradicted by any other inconsistent prior agreement or oral contemporaneous agreement.[27] Consequently, the inclusion of the above provision is not necessary under Texas law, but it does help establish that the parties' intended the contract in question to constitute a final expression of their agreement.[28]

The breadth of the integration provision should be consistent with the parties' intended final agreement. For instance, attorneys should consider specifically referencing in the integration clause any prior agreements, such as letters of intent or non-disclosure agreements that are intended to be superseded by the final agreement. Likewise, practitioners should consider including any additional agreements such as escrow agreements, non-compete agreements, purchase orders, or similar documents which supplement the final agreement. If such additional documents are named, further consideration should be given to the insertion of a "conflicts" provision to avoid possible inconsistencies between the documents. Finally, a broadly drafted integration provision, which includes the bracketed text above regarding representations and warranties may be the equivalent of a non-reliance clause thus depriving a party of the ability to successfully make a fraud or 10b-5 claim.[29]

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[27] *See* TEX. BUS. & COM. CODE ANN. § 2.202; ISG State Operations, Inc. v. Nat'l Heritage Ins. Co., Inc., 234 S.W.3d 711, 719-20 (Tex. App.—Eastland 2005, pet. denied).

[28] *See* TEX. BUS. & COM. CODE ANN. § 2.202; ISG State Operations, Inc. v. Nat'l Heritage Ins. Co., Inc., 234 S.W.3d 711, 719-20 (Tex. App.—Eastland 2005, pet. denied); Edascio, L.L.C. v. Nextiraone L.L.C., 264 S.W.3d 786, 796 (Tex. App.—Houston [1st Dist.] 2008, pet. denied).

[29] *See generally* Playboy Enter. Inc., v. Editorial Caballero, S.A. de C.V., 202 S.W.3d 250, 258-59 (Tex. App.—Corpus Christi, no pet.) (barring a plaintiff's fraudulent inducement claim because the contract contained a merger clause stating that there were "no representations, promises, warranties or undertakings other than those contained in

F. Time of the Essence

Most contracts contain a variety of time-specific provisions (e.g. payment dates, delivery dates, etc.). However, under Texas law, time is generally not considered to be of the essence in a contract unless it is specifically provided or if the circumstances clearly indicate that it was the intention of the parties.[30] As a result, the parties may not receive the benefit of negotiated performance dates unless they include a specific provision such as:

> Time of the Essence. Time is of the essence with respect to all provisions of this Agreement in which a definite time for performance is specified; provided, however, that the foregoing shall not be construed to limit or deprive a party of the benefits of any grace or use period provided for in this Agreement.

G. Severability

Texas recognizes a presumption that each provision of a contract is dependent on the others.[31] Thus, a single illegal provision could result in the entire contract being unenforceable. However, courts will strike an otherwise invalid or illegal provision that is not an essential part of the agreement.[32] Further, severability provisions similar to the following provide a clear expression of the parties to have the agreement remain in effect notwithstanding a finding that a particular provision is unenforceable:

> Severability. If one or more provisions of this Agreement are held to be unenforceable under applicable law, such provisions shall be excluded from this Agreement and the balance of the Agreement shall be interpreted as if such provisions were so excluded and shall be enforceable in accordance with its terms.

With respect to non-compete provisions, Texas follows the equitable modification doctrine, which allows a court to revise the scope and duration of the non-compete to be enforceable to the maximum extent possible.[33] In contrast, "blue pencil" jurisdictions will merely strike the offending language.

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this Agreement"); Spring Window Div., Inc. v. Blindmaker, Inc., 184 S.W.3d 840, 869-70 (Tex. App.—Austin 2006, pet. granted, judgm't vacated w.r.m.) (enforcing a merger clause in a license agreement as a disclaimer of reliance to bar a fraudulent inducement claim predicated on the subject of the contract); *but see* Dallas Farm Mach. Co. v. Reaves, 307 S.W.2d 233, 293 (Tex. 1957) (holding an integration clause did not preclude a fraudulent inducement claim); Warehouse Assocs. Corporate Centre II, Inc. v. Celotex Corp., 192 S.W.3d 225, 239 (Tex. App.—Houston [14th Dist.] 2006, pet. denied).

[30] *See* Laredo Hides Co., Inc., v. H&H Meat Prods. Co., Inc., 513 S.W.2d 210, 216 (Tex. Civ. App.—Corpus Christi 1974, writ ref'd n.r.e.); Siderius, Inc., v. Wallace Co., Inc., 583 S.W.2d 852, 863-64 (Tex. Civ. App.—Tyler 1979, no writ).

[31] *See* John R. Ray & Sons, Inc. v. Stroman, 923 S.W.2d 80, 86 (Tex. App.—Houston [14th Dist.] 1996, writ denied).

[32] *See* Beaumont v. Int'l Ass'n of Firefighters Local Union 399, 241 S.W.3d 208, 215 (quoting Williams v. Williams, 69 S.W.2d 867, 871 (Tex. 1978)).

[33] Peat Marwick Main & Co. v. Haass, 818 S.W.2d 381, 388 (Tex. 1991); *see also* TEX. BUS. & COM. CODE ANN. § 15.51(c).

H. Interpretation

Although an unambiguous agreement will be construed and enforced as written, parties often agree to deliberately ambiguous language to close negotiating gaps, preferring to leave certain troublesome provisions to the good faith future implementation of the contract.[34] This practice is potentially troublesome, as ambiguities in a contract will generally be interpreted against its drafter.[35] Accordingly, attorneys may avoid this result by including a provision similar to the following:

> Interpretation. No provision of this Agreement will be interpreted in favor of, or against, any of the parties hereto by reason of the extent to which any such party or its counsel participated in the drafting thereof or by reason of the extent to which any such provision is inconsistent with any prior draft hereof or thereof.

However, deliberate ambiguity is not the same as potentially ambiguous or poorly drafted language that a party knows is intended by the other party as conveying a specific interpretation. In the latter case, where one party's subjective understanding has been manifested objectively, courts will interpret the ambiguity against the other party if it knew or should have known of such understanding.[36]

V. CERTAIN DEFINED TERMS

A. Best Efforts

Agreements often require parties to use their respective "best efforts," "commercially reasonable efforts," or another similar standard in performing certain obligations. The prevailing belief among most contract lawyers is that "best efforts" is the most onerous of the efforts formulations requiring that the obligated party use its total capabilities or exhaust its available alternatives, regardless of cost. In comparison, they view "commercially reasonable" efforts as implying good faith action in light of relevant costs, difficulty and other relevant factors. However, Texas does not distinguish between these standards and will apply a measure of reasonableness even where the contract purports to require best efforts.[37]

As a result, if parties intend best efforts to require a heightened standard of performance, they should provide a specific definition. The following is a fairly commonly used formulation:

> "[B]est efforts" means the efforts that a prudent person desirous of achieving a result would use in similar circumstances to ensure that such result is achieved as expeditiously as possible.

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[34] Birnbaum v. Swepi LP, 48 S.W.3d 254, 257-58 (Tex. App.—San Antonio 2001, pet. denied).

[35] Republic Nat'l Bank of Dallas v. Nw. Nat'l Bank of Ft. Worth, 578 S.W.2d 109, 115 (Tex. 1978).

[36] *See* United Rentals, Inc. v. RAM Holdings, Inc., 937 A.2d 810, 845 (Del. Ch. 2007) (defining the foregoing as the principle of the "forthright negotiator").

[37] *See* TEX. BUS. & COM. CODE ANN. § 2.306(b), cmts. 2 and 5 (stating the essential test for best efforts is good faith, implying reasonable diligence in performance and requiring reasonable effort and due diligence); Herrmann Holdings Ltd. v. Lucent Tech. Inc., 302 F.3d 552, 558 (5th Cir. 2002) (measuring the quality of best efforts by comparing performance to that of an average, prudent, comparable person).

In comparison:

> "[C]ommercially reasonable efforts" means, with respect to a given outcome, the efforts, consistent with its past practice as well as consistent with the practice of comparable companies with respect to comparable products, that a reasonable person would use to achieve such outcome; provided, however, that such efforts shall not include any action or expenditure that is unduly burdensome under the circumstances.

As you can see, even the above "best efforts" language incorporates terminology often associated with a reasonableness standard. Therefore, if possible, the definition of best efforts should specify any goals or guidelines and include specific actions or examples of the scope and nature of the required efforts.

B. Material Adverse Effect

Parties in various types of agreements use "material adverse effect" or "material adverse change" to allocate risk or establish a threshold for breach or termination. Usually, a "material adverse effect" or "material adverse change" is thought to be such a particularly severe and, most likely unanticipated, event that it defeats the fundamental value or nature of the parties' agreement. Although agreements may just use the terminology without further definition, a defined term such as the following is more typical, especially in acquisition, investment and credit agreements:

> "[M]aterial adverse effect" means any event, circumstance, development or change that, individually or in the aggregate, has had a material adverse effect on the business, financial condition or results of operations of such person and any subsidiaries of such person taken as a whole.

Unfortunately, even this customary language does not really shed much light on what does or does not constitute a material adverse effect, and a party attempting to establish that a material adverse effect has occurred faces a difficult burden.[38] Accordingly, if possible, practitioners should identify specific, objective conditions that the parties agree would satisfy the definition of a material adverse effect.[39]

Although the absence of a specific event from the definition makes it more likely that the occurrence of such event will not constitute a material adverse effect, parties often negotiate strongly to exclude certain items from the operation of the definition. These excluded events tend to be of a more general nature, which allow parties to gain comfort in making representations regarding, or providing a termination right based upon, the occurrence of a material adverse effect from a particular date.

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[38] *See* Hexion Specialty Chems., Inc. v. Huntsman Corp., 965 A.2d 715, 738 (Del. Ch. 2008) (holding that the buyer in an acquisition must demonstrate that "there has been an adverse change in the target's business that is consequential to the company's long-term earnings power over a commercially reasonable period, which one would expect to be measured in years rather than months").

[39] *See, e.g.,* Nip v. Checkpoint Sys. Inc., 154 S.W.3d 767, 769-70 (Tex. App.—Houston [14th Dist.] 2004, no pet.) (finding the occurrence of a material adverse effect where the relevant definition included a monetary threshold); Borders v. KLRB, Inc., 727 S.W.2d 357, 359 (Tex. App.—Amarillo 1987, writ ref'd n.r.e.) (noting that a material adverse effect did not occur for a decline in radio ratings where the related definition did not include such metric).

Common exclusions are any effects resulting from:

(A) changes to the industry or markets in which the business of the company and its subsidiaries primarily operate that are not unique to such business;

(B) changes in economic or financial or capital markets conditions generally;

(C) a change or proposed change in any accounting standard, principle or interpretation;

(D) a change or proposed change in any law;

(E) the announcement or the execution of this Agreement, the pendency or consummation of the transactions contemplated hereby or the performance of this Agreement;

(F) the compliance with the terms of this Agreement or the taking of any action required or contemplated by this Agreement;

(G) any natural disaster;

(H) any acts of terrorism or war or the outbreak or escalation of hostilities or change in geopolitical conditions; provided that with respect to clauses (A), (B), (C), (D), (G) and (H), such matter does not disproportionately affect the company and its subsidiaries as compared to a similarly situated business operating in the principal business in which the company and its subsidiaries operate.

C. Knowledge

In the absence of a specific definition, "knowledge" will likely be limited to actual knowledge.[40] The definition of knowledge is often highly negotiated both in terms of the level of knowledge (i.e., actual vs. constructive) and the persons whose knowledge will be imputed to a particular party. The following form includes multiple options used by parties in a typical knowledge definition:

> "Knowledge" means, with respect to the Company, the [actual] knowledge of the following individuals: ______________, _______________, and ___________ [and any other director or officer of the Company or any Subsidiary and any other employee of the Company or any Subsidiary with a title of _______ or above] [without inquiry]. [For purposes of this Agreement, any such individual shall be deemed to have knowledge of a particular fact or other matter if (a) such individual is actually aware of such fact or other matter or (b) a prudent individual could be expected to discover or otherwise become aware of such fact or other matter after reasonable investigation].

[40] *See* TEX. BUS. & COM. CODE ANN. § 1.202.

VI. EXECUTION MATTERS

The signature page is perhaps the most important "boilerplate" part of the contract. No matter how well a contract is drafted, all of the attorneys' efforts will be for naught if the contract is not properly executed by the right parties. Great care should be taken to make sure that the names on the signature blocks are an exact match of the names in the introductory paragraph of the contract. In addition, the identity of the person signing the contract should be clear, and that person's capacity (president, vice president, etc.) should be specified. An example of an execution provision follows:

> IN WITNESS WHEREOF, the parties have executed this Agreement to be effective as of the date set forth above.
>
> XYZ, Inc.
>
> By:_________________
> Its:_________________
>
> ABC, LLC
>
> By:_________________
> Its:_________________

In addition, if the subject matter of the contract involves any potential community property rights of a married individual, attorneys should consider whether the signature of the party's spouse is required:

> The undersigned, being the spouse of Jane Doe, does hereby execute this Agreement for the express purpose of being bound by the provisions of Section ____ hereof.

Finally, if there are any other contractual limitations, such as a person executing an agreement under a power of attorney, or as a parent or guardian on behalf of a minor, those facts should be recited in the signature block as well.

VII. SUMMARY & CONCLUSION

Lawyers spend considerable time and effort negotiating various provisions of agreements governing consideration, indemnification, covenants, representations and other matters central to a business arrangement only to see these provisions inadvertently undone or amended by so-called "boilerplate" provisions. As illustrated in this article, while "boilerplate" provisions can be useful to narrow issues or save transaction costs, careful consideration of these provisions is nevertheless necessary to properly protect clients' interests and to ensure that the final agreement is consistent with the parties' intent.

VIII. APPENDIX A: FORMS OF OTHER COMMON BOILERPLATE PROVISIONS

Conflicts. In the event of any conflict in the terms and provisions of this Agreement and the terms and provisions of [Agreement X], the terms and provisions of this Agreement shall control.

Counterparts. This Agreement may be executed in counterparts, each of which shall be deemed an original, but all of which taken together shall constitute one and the same instrument. Facsimile and .pdf signatures to this Agreement shall be acceptable and binding.

Cumulative Remedies. The rights and remedies under this Agreement are in addition to and not exclusive of any other rights, remedies, powers and privileges whether at law, in equity under this Agreement or otherwise, that any party may have against another. No failure to exercise and no delay in exercising any right, power or privilege shall operate as a waiver thereof, nor shall any single or partial exercise of any right, power or privilege preclude the exercise of any other right, power or privilege. No waiver of any breach of any covenant or agreement hereunder shall be deemed a waiver of a preceding or subsequent breach of the same or any other covenant or agreement.

Expenses. Except as otherwise provided herein, each party shall pay its own costs and expenses incurred in connection with this Agreement and its performance hereunder; provided, however, that if any suit or other proceeding is brought for the enforcement or interpretation of this Agreement, or because of any alleged dispute, breach, default or misrepresentation hereunder, the successful or prevailing party shall be entitled to recover from the other party reasonable attorneys' fees and other costs incurred in connection therewith.

Force Majeure. Neither party shall be liable for any delay or failure in performance due to any reason or unforeseen circumstance beyond the affected party's reasonable control, including, shortages or delays in obtaining materials from suppliers that cannot reasonably be cured by obtaining the needed materials from another source, work stoppages not involving employees of either party that cannot reasonably be overcome, fires, riots, rebellions, wars, acts of terrorism, accidents, explosions, floods, storms, acts of God, and similar occurrences. The obligations and rights of the excused party shall be extended on a day-to-day basis for the time period equal to the period of the excusable delay.

Further Assurances. Each of the parties hereto shall execute and deliver all requested documents and instruments and shall do any and all acts and things reasonably requested (a) in connection with the performance of the obligations undertaken in this Agreement, (b) to perfect and evidence the transactions contemplated by this Agreement, and/or (c) otherwise to effectuate in good faith the intent of the parties and the purposes of this Agreement.

Interpretive Matters. Unless the context otherwise requires, (a) all references to Sections, Articles or Schedules are to Sections, Articles or Schedules of or to this Agreement, (b) the singular form includes the plural form and *vice versa*, (c) "or" is disjunctive but not necessarily exclusive, (d) masculine, feminine and neuter forms all include the other, and (e) the word "including" and similar terms following any statement will not be construed to limit the statement to matters listed after such word or term, whether or not a phrase of non-limitation such as "without limitation" is used.

Liquidated Damages. Notwithstanding any contrary provision contained herein, in the event of a material breach by either party of its obligations under this Agreement, the only damages payable to the Nondefaulting party shall be a lump sum monetary payment equal to $[amount]

plus any attorneys' fees and costs incurred by the Nondefaulting party to obtain, if necessary, a final judgment or arbitration determination that the defaulting party has materially breached its obligations under this Agreement. In the event a party alleged to be in material breach under this Agreement (Defaulting Party) challenges the applicability or efficacy of this provision or if this provision is held to be void or unenforceable for any reason, the Nondefaulting Party shall be entitled to any and all other damages and remedies otherwise provided at law, including attorneys' fees.

Publicity. Upon consummation of the transactions contemplated hereby, except as required by applicable law or stock exchange or similar rules, neither party shall disclose the terms of or the existence hereof (except to advisors and financing sources who have a need to know or who are otherwise subject to a confidentiality restriction) without the other party's prior written consent.

Relationship of the Parties. The relationship of the parties is that of independent contractors. The parties are not, by virtue of this Agreement or otherwise, in an employer-employee, principal-agent, joint venture or partnership relationship with each other, and each party agrees not to represent to any other person, or to assert in any form or forum to the contrary. Neither party is authorized to act as an agent for, or legal representative of, the other party and neither party shall have authority to assume or create any obligation on behalf of, in the name of, or binding upon the other party. Each party acknowledges that it is responsible for its own tax withholding and other obligations with regard to its own employees.

Specific Performance. Each party hereby agrees that irreparable damages would occur in the event that any of the provisions of this Agreement were not performed by them in accordance with the terms hereof and that each party shall be entitled to specific performance of the terms hereof, in addition to any other remedy at law or in equity.

Titles & Headings. Titles and headings of sections of this Agreement are for convenience of reference only and shall not affect the construction of any provision of this Agreement.

IX. APPENDIX B: SUGGESTED READING & RESOURCES LIST

Kenneth A. Adams, *Understanding 'Best Efforts' and its Variants (Including Drafting Recommendations)*, 50 PRAC. LAW. No. 4, Aug. 2004.

Mark E. Betzen & Richard Meamber, *Rule 10b-5 and Related Considerations in Acquisition Agreements*, THE METRO. CORP. COUNS., Aug. 1, 2004, at 10.

Shawn Helms, *Analyzing Conventional Wisdom: The 'Best Efforts' Standard*, DALLAS BAR ASS'N. (Headnotes, Dallas, Tex.), Feb. 1, 2007, at 8.

Curt M. Langley & Jason T. Martin, Presentation for the State Bar of Texas Continuing Legal Education: Boilerplate Terms, Rules of Interpretation, and Developments in Drafting Contracts (May 29, 2003).

Tina L. Stark, NEGOTIATING AND DRAFTING CONTRACT BOILERPLATE (2003).

Steven O. Weise & Mikel R. Bistrow, *Boilerplate Provisions in Transactional Documents: How to Stay Out of Trouble*, 20 CAL. BUS. L. PRACTITIONER 33 (Summer 2005).

D. Hull Youngblood, Jr. & Seth E. Meisel, Presentation for State Bar of Texas Continuing Legal Education: Seven Deadly Sins of Boilerplate: "Cut-and-Paste Can Get You Sued (April 29-30, 2010).

Hexion Specialty Chems., Inc. v. Huntsman Corp., 965 A.2d 715 (Del. Ch. 2008).

United Rentals, Inc. v. RAM Holdings, Inc., 937 A.2d 810 (Del. Ch. 2007).

X. APPENDIX C: MODEL ARBITRATION CLAUSES

Typical Broad Form Arbitration Clause
Any dispute, controversy, or claim arising out of, relating to, or in any way connected with this Contract, including, without limitation, the existence, validity of performance, breach, or termination thereof, shall be settled by final and binding arbitration in accordance with the following arbitration rules:

[Name governing body]
The seat of the arbitration shall be *[City, Country]*. The language of the arbitration shall be English. Within thirty (30) days of the respondent's receipt of notice of arbitration, each party shall select an arbitrator, and within fifteen (15) days of selection of the second arbitrator the two arbitrators shall select the third, who shall serve as Chair. In the event that any party fails to timely appoint its arbitrator or the two party-selected arbitrators are unable to agree on a third, the [governing body] shall appoint the arbitrator(s) who have not been timely designated. The arbitrator(s) shall be qualified by education, training, or experience to determine the dispute, controversy, or claim.

United Nations Commission on International Trade Law (UNCITRAL) Model Clause**:**
PERMANENT COURT OF ARBITRATION, *UNCITRAL Rules and Model Clause*, www.pca-cpa.org/showpage.asp?pag_id=1190 (last visited Feb. 17, 2011).
Any dispute, controversy, or claim arising out of or relating to this contract, or the breach, termination, or invalidity thereof, shall be settled by arbitration in accordance with the UNCITRAL Arbitration Rules in effect on the date of this contract.

The appointing authority shall be the Secretary-General of the Permanent Court of Arbitration. The case shall be administered by the International Bureau of the Permanent Court of Arbitration in accordance with the "Permanent Court of Arbitration Procedures for Cases under the UNCITRAL Arbitration Rules."

Note: parties might wish to consider adding:

(a) The number of arbitrators shall be … [one or three].
(b) The place of arbitration shall be … [insert city and country].
(c) The language(s) to be used in the arbitral proceedings shall be … [insert choice].

London Court of International Arbitration (LCIA) Model Clause:
THE LONDON COURT OF INTERNATIONAL ARBITRATION, *Recommended Clauses*, www.lcia.org (last visited Feb. 17, 2011).
Any dispute arising out of or in connection with this contract, including any question regarding its existence, validity or termination, shall be referred to and finally resolved by arbitration under the Rules of the LCIA, which Rules are deemed to be incorporated by reference into this clause.

The number of arbitrators shall be [one/three].

The seat, or legal place, of arbitration shall be [City and/or Country].
The language to be used in the arbitral proceedings shall be [ ].
The governing law of the contract shall be the substantive law of [ ].

Court of Arbitration of the International Chamber of Commerce (ICC) Model Clause:
INT'L CHAMBER OF COMMERCE, *Int'l Court of Arbitration Dispute Resolution Services*, *Standard ICC Arbitration Clause*,
www.iccwbo.org/court/arbitration/id4090/index.html (last visited Feb. 17, 2011).
All disputes arising out of or in connection with the present contract shall be finally settled under the Rules of Arbitration of the International Chamber of Commerce by one or more arbitrators appointed in accordance with the said Rules.

[Note: Parties are reminded that] it may be desirable for them to stipulate in the arbitration clause itself the law governing the contract, the number of arbitrators, and the place and language of the arbitration.]

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TOP TEN EMERGING ISSUES FACING TRIAL LAWYERS IN BUSINESS TORTS AND COMMERCIAL LITIGATION

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I. CAN PARTIES NOW CONTRACT AWAY THEIR OWN FRAUD? THE ENFORCEABILITY OF A WAIVER-OF --RELIANCE PROVISION IN AGREEMENTS AS CONCLUSIVELY NEGATING A LATER RAISED CLAIM FOR FRAUDULENT INDUCEMENT. *FOREST OIL CORP. V. MCALLEN*, 268 S.W.3D 51 (TEX. 2008)

In *Forest Oil Corp. v. McAllen*, the most recent decision on the enforceability of a waiver-of-reliance provision in an agreement, the Texas Supreme Court made it clear that the trend is toward barring fraud claims where parties previously agreed in writing not to rely on one another in the transaction at issue.[1] If the parties are operating at arms-length, through their own lawyers and with a waiver-of-reliance provision included in the agreement, it is now increasingly difficult to maintain a claim for fraud even if there are fact issues to the contrary.

The line of cases preceding *Forest Oil* starts with *Prudential Insurance Co. of America v. Jefferson Associates, Ltd.*[2] In *Prudential*, Goldman purchased the Jefferson Building in Austin from The Prudential Insurance Company of America ("Prudential").[3] Approximately two years later, Goldman discovered that the building contained asbestos fireproofing.[4] Goldman sued Prudential. Goldman contended that Prudential misrepresented the condition of the building and failed to disclose that it contained asbestos undermined its value.[5] In response, Prudential argued that Goldman purchased the building "as is"; therefore, he could not recover damages.[6]

The Texas Supreme Court held that Goldman's agreement to purchase the Jefferson Building "as is" precluded any argument that Prudential proximately caused any alleged damages.[7] *Prudential* reasoned that where there is an agreement to purchase something "as is", the buyer consents to making his own appraisal and accepts any risk that he may be incorrect.[8] When Goldman acknowledged that he was not relying upon any representation with respect to the condition of the property, the "as is" agreement negated any claim that Prudential caused his injury.[9] However, the Texas Supreme Court held that an "as is" agreement does not preclude a fraudulent inducement claim.[10] *Prudential* held:

> A seller cannot have it both ways: he cannot assure the buyer of the condition of a thing to obtain the buyer's agreement to purchase 'as is', and then disavow the assurance which procured the 'as is' agreement. Also, a buyer is not bound by an "as is" agreement if he is entitled to inspect the condition of what is being sold but is impaired by the seller's conduct. A seller cannot obstruct an inspection for defects in his property and still

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1 Forest Oil Corp. v. McAllen, 268 S.W.3d 51, 53 (Tex. 2008).

2 Prudential Ins. Co. of Am. v. Jefferson Assocs., Ltd., 896 S.W.2d 156, 161-62 (Tex. 1995).

3 *Id.* at 159.

4 *Id.*

5 *Id.*

6 *Id.*

7 *Prudential*, 896 S.W.2d at 161.

8 *Id.* (citations omitted).

9 *Id.*

10 *Id.* at 162.

> insist that the buyer take it 'as is'. In circumstances such as these an 'as is' agreement does not bar recovery against the seller.[11]

Prudential provided two noteworthy exceptions to the enforceability of "as-is" or waiver-of-reliance provisions in an agreement.[12] The first exception is the inducement of the injured party to execute an agreement by the concealment of information by the very party seeking to enforce the language in the agreement.[13] The second exception is that a purchaser is not bound by an "as is" agreement if he is entitled to inspect the condition of what is being sold but is impaired from doing so by the seller's conduct.[14] Thus, a seller cannot obstruct an inspection for defects in his property and still insist that the purchaser take it "as is."[15] In these two limited circumstances, an "as is" agreement does not bar recovery against the purchaser.[16]

Two years after *Prudential*, the Texas Supreme Court issued its opinion in *Schlumberger Technology Corp. v. Swanson*.[17] In *Schlumberger*, the Court reasoned that both exceptions carved out in *Prudential* are still legally enforceable; however, held under the fact pattern presented in *Schlumberger,* fraudulent inducement did not prevent the court from enforcing the waiver-of-reliance language in the release executed by the Swansons.[18]

The issue in *Schlumberger* and its progeny was whether a contractual disclaimer precluded, as a matter of law, a claim that a party was fraudulently induced into executing the agreement.[19] ("The question is whether this disclaimer precludes, as a matter of law, the Swanson's from recovering damages against Schlumberger for fraudulently inducing them to settle."). Schlumberger Technology Corporation ("Schlumberger") sought to purchase the Swanson's interest in an underwater diamond mining operation.[20] After becoming embroiled in a dispute over the value of their interests, the Swansons agreed to a price and sold their interest to Schlumberger.[21] As part of the transaction, the Swansons signed a release. In the release, the parties specifically noted the interest's value was in dispute, the release extinguished the Swansons interest, and the agreement included a waiver-of-reliance provision.[22] The Swansons later sued Schlumberger asserting that Schlumberger fraudulently induced them to enter into this transaction.[23]

In discussing the enforceability of the waiver-of-reliance provision, the Texas Supreme Court began with a presumption that Schlumberger had fraudulently induced the Swansons to enter into the transaction and sign the release.[24] The Texas Supreme Court rejected Schlumberger's argument that, as long as the releasing party was represented by counsel in an

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

[12] *Id.*

[13] *See Prudential*, 896 S.W.2d at 161-62.

[14] *Id.*

[15] *Id.*

[16] *Id.*

[17] Schlumberger Tech. Corp. v. Swanson, 959 S.W.2d 171, 179 (Tex. 1997).

[18] *See id.* at 179-81.

[19] *Id.* at 173.

[20] *Id.* at 173-74.

[21] *Id.* at 174.

[22] *Id.* at 180.

[23] *Schlumberger*, 959 S.W.2d at 174.

[24] *Id.* at 174, 178.

arms-length transaction, a waiver-of-reliance provision in a release bars a claim that the releasing party was fraudulently induced to sign the release.[25]

In *Schlumberger*, the Texas Supreme Court recognized prior precedent that held that a release could be set aside upon proof of fraudulent inducement, even if the release contains a waiver-of-reliance provision.[26] However, *Schlumberger* also acknowledged that there were cases that reached the opposite result.[27] The Court stated that these two conflicting lines of authority were resolved in *Dallas Farm Machinery Co. v. Reaves*, decided four decades earlier, in which the court adhered to the former line of cases that refuse to enforce fraudulently induced waiver-of-reliance provisions.[28] *Schlumberger* recognized that the holding in *Dallas Farm Machinery* brought Texas law into compliance with the overwhelming weight of authority in other jurisdictions, the Restatement of Contracts, and the opinions of legal scholars.[29]

After appearing to follow *Dallas Farm Machinery Co.,* the *Schlumberger* court then stated that there was a previously unaddressed competing concern; the ability of the parties to resolve their disputes without further litigation.[30] Reasoning that parties should be able to release each other from further disputes, *Schlumberger* held that circumstances may exist under which a contracting party can disclaim reliance on misrepresentations as to defeat a claim of fraudulent inducement as a matter of law.[31] According to *Schlumberger*, a disclaimer of reliance under certain circumstances may conclusively negate the element of reliance; a required element to maintain a fraudulent inducement claim.

In so illustrating, *Schlumberger* relied upon *Prudential Insurance Co.* and *Estes v. Hartford Accident & Indemnity Company*.[32] Although *Prudential* did enforce a waiver-of-reliance provision in an agreement, the part of that opinion relied upon by *Schlumberger* refers to *Dallas Farm Machinery Co.* and notes that the same language is unenforceable against a purchaser induced to enter into an agreement by the seller's misrepresentations.[33] The other case cited by *Schlumberger*, *Estes v. Hartford Accident & Indemnity Co.,* held there was no evidence of reliance on the alleged fraudulent misrepresentation that induced the party to execute a release.[34] However, *Estes* does not say that the release contained a waiver-of-reliance clause and the court states that the release would be unenforceable if the releasing party had proven fraud.[35]

Schlumberger elaborated upon the circumstances in which a waiver-of-reliance provision may negate proof of fraudulent inducement. *Schlumberger* held:

> The contract and the circumstances surrounding its formation determine whether the disclaimer of reliance is binding. Because the parties were

[25] *Id.* at 175, 178.

[26] *Id.* at 178.

[27] *Id.* at 178-79.

[28] *Id.* at 179 (discussing Dallas Farm Mach. Co. v. Reaves, 307 S.W. 2d 233 (Tex. 1957)).

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

[30] *See id.*

[31] *See id.*

[32] *Prudential*, 896 S.W.2d at 161-62; Estes v. Hartford Accident & Indem. Co., 46 S.W.2d 413, 417-18 (Tex. Civ. App.—El Paso 1932, pet. ref'd).

[33] *See Prudential,* 896 S.W.2d at 161-62.

[34] *See Estes*, 46 S.W.2d at 417-18.

[35] *Id.* at 417.

> attempting to put an end to their deal, and had become embroiled in a dispute over the feasibility and value of the project, we conclude that the disclaimer of reliance the Swansons gave conclusively negates the element of reliance.[36]

It was significant in *Schlumberger* that during the negotiations that led to the execution of the release, the parties could not agree upon the value of the Swanson's interest.[37] Thus, the very purpose of the release was to conclude the dispute as to the value of Swansons' interest.[38] Because the Swansons disclaimed any reliance upon Schlumberger about the value of their interest, the Swansons intended to forego relying upon any representations about the value of the project.[39]

Schlumberger underscored the point that a waiver-of-reliance provision will not necessarily preclude a fraudulent-inducement claim and observed that *Prudential* had identified some situations in which an "as-is" clause would not bar a similar claim.[40] As noted above, the language in *Prudential* relied upon in *Schlumberger* includes a citation to *Dallas Farm Machinery Co.* and recognizes that the purchaser would not have been bound by an "as-is" clause that contained similar waiver-of-reliance language if it had been induced to execute an agreement by a fraudulent representation.[41] After recognizing that the exceptions from *Prudential* are still valid, *Schlumberger* opined, "We conclude *only* that on this record, the disclaimer of reliance conclusively negates as a matter of law the element of reliance on representations about the feasibility and value of the sea-diamond mining project needed to support the Swansons' claim of fraudulent inducement."[42]

If *Schlumberger* is interpreted broadly, its holding could be applied in many situations where two common factors exist: (1) an arm's length transaction occurs between sophisticated parties that are represented by independent legal counsel and (2) waiver-of-reliance language that unequivocally applies to the very representations upon which the injured party makes its complaint is included in the contract. Moreover, a broad application of *Schlumberger* would have the practical effect of overruling the fraudulent-inducement exceptions established in *Prudential* and many other authorities indicate the case is still good law.[43]

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[36] *Schlumberger*, 959 S.W.2d at 179-80 (citations omitted).

[37] *See id.* at 180.

[38] *Id.*

[39] *Id.*

[40] *Id.* (citing *Prudential*, 896 S.W.2d at 162).

[41] *Id; Prudential*, 896 S.W.2d at 162.

[42] *See* Schlumberger, 959 S.W.2d at 181 (emphasis added).

[43] *See* Geodyne Energy Income Prod. P'ship I-E v. Newton Corp., 161 S.W.3d 482, 487, 490 & n. 32 (Tex. 2005) (holding that a quitclaim deed containing an as-is provision did not violate the Texas Securities Act, but noting the two *Prudential* exceptions and observing that the reasoning would change if there were evidence of fraudulent inducement); Schlumberger, 959 S.W.2d at 181; Kane v. Nxcess Motorcars, Inc., No. 01-04-00547-CV, 2005 WL 497484, at *6-7 (Tex. App.—Houston [1st Dist.] Mar. 3, 2005, no pet.) (reversing summary judgment based upon as-is clause because fact issues were raised as to fraudulent-inducement exception); Bynum v. Prudential Residential Servs., Ltd. P'ship, 129 S.W.3d 781, 787-92 (Tex. App.—Houston [1st Dist.] 2004, pet. denied) (applying *Prudential* exceptions to an agreement containing waiver-of-reliance and as-is provisions and finding that summary-judgment evidence did not raise a fact issue as to those exceptions); Nelson v. Najm, 127 S.W.3d 170, 173, 175-76 (Tex. App.—Houston [1st Dist.] 2003, pet. denied) (applying *Prudential* to an agreement containing both waiver-of-reliance and as-is language and finding that fraud claims were not barred because there was evidence that the seller fraudulently concealed information from the purchaser).

The Texas Supreme Court continued to blaze this trail with its most recent decision in *Forest Oil Corp. v. McAllen.*[44] At issue in *Forest Oil* was whether an unambiguous waiver-of-reliance provision precluded a fraudulent inducement claim as a matter of law.[45] Because *Forest Oil* involved sophisticated parties represented by counsel in an arms-length transaction, the Texas Supreme Court held that the waiver-of-reliance provision conclusively negated the element of reliance; therefore, any claim for either fraud or fraudulent inducement was contractually barred.[46] In *Schlumberger*, the Court held that a fraudulent inducement claim was precluded by a contractual disclaimer. This principle was re-affirmed in *Forest Oil*.[47] However, in Forest Oil and *Schlumberger* the Court expressly declined "to adopt a *per se* rule that a disclaimer of reliance automatically precludes a fraudulent-inducement claim...."[48] Rather, it stated, "Courts must always examine the contract itself and the totality of the surrounding circumstances when determining if a waiver-of-reliance provision is binding."[49]

The Court articulated several factors that are of paramount importance in making this determination: (i) whether the contract was negotiated or boilerplate, (ii) whether the complaining party was represented by counsel, (iii) whether the parties dealt with each other at arms-length, (iv) whether the parties were knowledgeable in business matters, (v) and whether the release language was clear.[50] The Court also considered how the disclaimer provision impacted the plaintiffs' remaining claims for common-law and statutory fraud.[51] Upon attempting to clarify *Schlumberger*, the Court observed that, "*Schlumberger* holds that when knowledgeable parties expressly discuss material issues during contract negotiations but nevertheless elect to include waiver-of-reliance and release-of-claims provisions, the Court will generally uphold the contract**.** An all-embracing disclaimer of any and all representations, as here, shows the parties' clear intent."[52]

In a nutshell, *Forest Oil* holds that under certain circumstances parties can contract away their own fraudulent misrepresentations. In light of *Forest Oil*, it is now prudent for the lawyer in all transactions to include waiver-of-reliance provisions in settlement agreements and other contracts. It is also prudent to place language in the agreement encouraging the other party to obtain independent counsel to review the contract and have the opposing party initial such a provision. Furthermore, it is in the best interests of the parties to include language in the agreement that the final version of the contract was revised based upon the negotiations between the parties. By providing such language in your clients' business agreements, your

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[44] *Forest Oil*, 268 S.W.3d at 51.

[45] *Id.* at 52.

[46] *Id.* at 52-53.

[47] *See id.* at 52-53 (unambiguous waiver-of-reliance provision precludes fraudulent inducement claim as a matter of law).

[48] *Id.* at 61; *Schlumberger*, 959 S.W.2d at 181 ("We emphasize that a disclaimer of reliance or merger clause will not always bar a fraudulent inducement claim.").

[49] *Forest Oil*, 268 S.W.3d at 60.

[50] *Id.*; *see Schlumberger*, 959 S.W.2d at 179-81.

[51] *Schlumberger,* 959 S.W.2d at 181-82.

[52] *Forest Oil Corp*., 268 S.W.3d at 58; *see also* Jacuzzi, Inc. v. Franklin Elec. Co. Inc., CIV.A. 3:07-CV-1090-, 2008 WL 190319, at *4 (N.D. Tex. Jan. 22, 2008) (Fitzwater, J.) (enforcing a "no reliance" disclaimer); Whitney Nat. Bank v. Air Ambulance by B & C Flight Mgmt. Inc., CIV.H-04-2220, 2007 WL 1256612, at *8-13 (S.D. Tex. Apr. 30, 2007) (standard merger clauses barred fraudulent inducement claim); Stark v. Benckenstein, 156 S.W.3d 112, 122-23 (Tex. App.—Beaumont 2004, pet. denied) ("Here the release, as in *Schlumberger*, covers all claims, whether known or unknown and further disclaims reliance on representations about the specific matter in dispute. The Parties here were represented by counsel, and bargained at arm's length over the Agreement's terms. The final Agreement contained releases of claims and a payment of cash.") (citations omitted).

client will likely be protected from further litigation that could evolve from the transaction in question.

II. THE TEXAS SUPREME COURT IS TAKING A BRIGHT LINE APROACH TO ENFORCING CONTRACTS AS WRITTEN, REGARDLESS OF THE POLICY RAMIFICATIONS, TO PROVIDE CERTAINTY AND CONSISTENCY IN BUSINESS TRANSACTIONS. *FORTIS BENEFITS V. CANTU*, 234 S.W.3D 642 (TEX. 2007).

The macro approach to *Forest Oil* is that the Texas Supreme Court seems to be telling businesses, corporations, and sophisticated parties that the Court is simply not going to rewrite contracts executed between business players even if it bars a later lawsuit between them regarding a specific transaction. That theme is particularly true in *Fortis Benefits v. Cantu*,[53] where the Supreme Court enforced the plain language of an insurance policy that provided for contractual subrogation and ignored the made whole doctrine.

There are three types of subrogation: contractual, statutory, and equitable.[54] In Texas, the case law typically addresses contractual (or "conventional") subrogation and equitable subrogation.[55] To prevail on an equitable subrogation claim, a party must establish that it involuntarily paid a debt that is primarily owed by another party that, in equity, should have been incurred by the other party.[56] In contrast, contractual subrogation is "created by an agreement or contract that grants the right to pursue reimbursement from a third party in exchange for payment of a loss…."[57]

Under either form of subrogation, ***the insurer stands in the shoes of the*** insured and may assert only those rights held by the insured against the third party subject to any defenses of the third party against the insured.[58] The underlying principle of subrogation is that once an insured is made whole from its damages, the insurer that paid those losses is entitled to the insured's rights and remedies against a third party for the covered claims.[59] In Texas, the courts are "particularly hospitable" to the concept.[60]

Absent an agreement to the contrary, subrogation is based on equity and the appellate courts will not disturb a trial court's balancing of the equities unless "it would be inequitable to

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[53] Fortis Benefits v. Cantu, 234 S.W.3d 642, 643 (Tex. 2007).

[54] *See id.* at 648.

[55] *See* Mid-Continent Ins. Co. v. Liberty Mut. Ins. Co., 236 S.W.3d 765, 774 (Tex. 2007); *see also* Hartnett v. Hampton Inns, Inc., 870 S.W.2d 162, 167 n. 7 (Tex. App.—San Antonio 1993, pet. denied) (a right to subrogation may arise either from a contract or in equity to prevent fraud).

[56] *Mid-Continent*, 236 S.W.3d at 774; Frymire Eng'g Co. v. Jomar Intern., Ltd., 259 S.W.3d 140, 142, 144-46 (Tex. 2008).

[57] *Mid-Continent*, 236 S.W.3d at 774; *Hartnett*, 870 S.W.2d at 167 n. 7 (noting that contractual subrogation rights are enforceable).

[58] *Mid-Continent*, 236 S.W.3d at 774.

[59] Harris v. Am. Prot. Ins. Co., 158 S.W.3d 614, 622 (Tex. App.—Fort Worth 2005, no pet.).

[60] *Id.* (quoting Interfirst Bank Dall., N.A. v. U.S. Fid. & Guar. Co., 774 S.W.2d 391, 397 (Tex. App.—Dallas 1989, writ denied)); *see* Rowland & Rowland, P.C. v. Tex. Emp'rs Indem. Co., 973 S.W.2d 432, 436 (Tex. App.—Austin 1998, no pet.) ("…there is an abundance of case law in which Texas courts have manifested their interest in examining settlements in third-party actions to ensure an insurance carrier's right to subrogation").

allow the judgment to stand."[61] If either the insurer or the insured "must to some extent go unpaid, the loss should be borne by the insurer for that is a risk the insured has paid the insurer to assume."[62] An insurer is not entitled to equitable subrogation until the insured is "made whole" for his loss.[63]

In *Fortis Benefits v. Cantu,*[64] Vanessa Cantu ("Cantu") sustained catastrophic injuries in an automobile accident.[65] Cantu sued the driver of the vehicle, the driver's employer, and Ford Motor Company.[66] Cantu settled her claims for $1.445 million.[67] Cantu's past medical expenses totaled $378,500 of which Fortis claimed to have paid $247,534.14.[68] Cantu obtained two life care plans estimating that her need for future medical care could be as high as $5,300,000.[69] Cantu obtained summary judgment in the trial court that Fortis was not entitled to recover the medical benefits that it paid because Cantu had not been made whole by the settlement.[70] The Texas Supreme Court reversed and held that Fortis was entitled to recover the full amount of the lien because the insurance policy contained a contractual subrogation provision.[71]

Under Fortis, if an agreement provides for subrogation, irrespective of whether the insured is first made whole, "[t]he contract's specific language controls . . . and the equitable defense of the 'made whole' doctrine must give way."[72] "[C]ontract-based subrogation rights should be governed by the parties' express agreement and not invalidated by equitable considerations that might control by default in the absence of an agreement."[73]

In noting the distinctions between contractual and equitable subrogation in Fortis, the Texas Supreme Court observed that while the two concepts rest on common principles and are somewhat similar, they are separate and distinct rights independent of each other.[74] In *Fortis*, the Texas Supreme Court underscored that, although the two rights are separate and independent, that does not suggest that they are co-equal, observing that equitable doctrines must reconcile with contractual agreements, "not the other way around."[75] A contractual subrogation right stems directly from the contract executed between the parties and does not derive its existence from amorphous principles of equity.[76]

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[61] Esparza v. Scott & White Health Plan, 909 S.W.2d 548, 552 (Tex. App.—Austin 1995, writ denied) (abrogated by Fortis Benefits v. Cantu, 234 S.W.3d 642 (Tex. 2007)).

[62] Ortiz v. Great S. Fire & Cas. Ins. Co., 597 S.W.2d 342, 344 (Tex. 1980) (quoting Garrity v. Rural Mut. Ins. Co., 253 N.W.2d 512, 514 (Wis. 1977)).

[63] *Esparza*, 909 S.W.2d at 552; *Ortiz*, 597 S.W.2d at 343.

[64] *Fortis*, 234 S.W.3d at 648.

[65] *Id*. at 644.

[66] *Id*.

[67] *Id*.

[68] *Id*.

[69] *Id*.

[70] *Fortis Benefits*, 234 S.W.3d at 644.

[71] *Id*.

[72] *Id*. at 651.

[73] *Id*. at 650.

[74] *Id*. at 648.

[75] *Id*.

[76] *Fortis*, 234 S.W.3d at 647.

> "The policy declares the parties' rights and obligations, which are not generally supplanted by court-fashioned equitable rules that might apply, as a default gap-filler, in the absence of a valid contract . . . Contractual subrogation clauses express the parties' intent that reimbursement should be controlled by agreed contract terms rather than external rules imposed by the courts."[77]

"Where a valid contract prescribes particular remedies or imposes particular obligations, equity generally must yield unless the contract violates positive law or offends public policy."[78] Moreover, a contractual subrogation clause does not violate Texas public policy.[79] Thus, according to *Fortis,* a contractual subrogation provision must be enforced as written, subject to general contract law principles of construction.[80]

Unlike *Forest Oil* where the parties had negotiated at arms-length with their own lawyers, in *Fortis* the Supreme Court interpreted an arguably boilerplate insurance contract and held that the policy would be enforced against Cantu as written. *Fortis* underscores the theme in the Texas Supreme Court that it is reluctant to re-write agreements, insurance policies, or to even find that certain language is unenforceable despite any result that may necessarily ensue. It was forcefully argued by Cantu in *Fortis* that the insurance company should bear the risk that it would not be reimbursed if Cantu was not made whole because that is the entire concept behind insurance. The Texas Supreme Court rejected this argument. *Fortis* leaves the door open for insurers to test the boundaries of reasonableness in insurance policies.

III. CAN LAWYERS REASONABLY ANTICIPATE THAT THE PATTERN JURY INSTRUCTION FOR PROXIMATE CAUSE WILL CHANGE IN COMMERCIAL CASES IN LIGHT OF THE HOLDINGS IN *FORD MOTOR CO. V. LEDESMA*, 242 S.W.3D 32 (TEX. 2007) AND *WAL-MART STORES, INC. V. MERRELL*, NO. 09-0224, 2010 WL 2431635 (TEX. JUNE 18, 2010?

In Texas, the overwhelming number of commercial and business torts require proof of proximate causation.[81]

In *Ford Motor Co. v. Ledesma,*[82] a products liability decision, the Supreme Court held that the pattern jury instruction on a manufacturing defect and on producing cause was clearly erroneous and reversible error. In *Ledesma*, Ford argued that the trial court improperly instructed the jury on producing cause. The trial judge, following the pattern jury instruction, instructed the jury: "Producing cause means an efficient, exciting, or contributing cause that, in a natural sequence, produces the incident in question. There may be more than one producing

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[77] *Id.* at 647-48.

[78] *Id.* at 648-49.

[79] *See id.* at 649.

[80] *Id.* at 648 n. 36, 650, 650 n. 54.

[81] *See, e.g.,* Forbes Inc. v. Granada Biosciences, Inc., 124 S.W.3d 167, 170 (Tex. 2003) (business disparagement requires proof of proximate cause); *see also* Abetter Trucking Co. v. Arizpe, 113 S.W.3d 503, 508 (Tex. App.—Houston [1st Dist.] 2003, no pet.) ("to recover for breach of fiduciary duty, the jury was required to find the existence of a fiduciary duty, breach of the duty, *causation*, and damages.") (citations omitted); Gray v. Woodville Healthcare Center, 225 S.W.3d 613, 617 (Tex. App.—El Paso 2006, pet. denied) ("As we have noted, this lawsuit alleged medical malpractice, gross negligence, and negligence *per se.* Proximate cause is an element for each of these causes of action.") (citations omitted); Larsen v. Carlene Langford & Assocs., Inc., 41 S.W.3d 245, 249 (Tex. App.—Waco 2001, pet. denied) (fraud and negligent misrepresentation require proof of proximate cause).

[82] Ford Motor Co. v. Ledesma, 242 S.W.3d 32 (Tex. 2007).

cause."[83] Ford's contention was that the producing cause instruction was incorrect; rather, according to Ford, the proper instruction should be that producing cause "means that cause which, in a natural sequence, was a substantial factor in bringing about an event, and without which the event would not have occurred. There may be more than one producing cause."[84]

The Supreme Court held that the second part of the definition, that "there may be more than one producing cause," was legally correct.[85] But *Ledesma* also held that producing cause "is a *substantial factor* that brings about injury and without which the injury would not have occurred."[86] The Court reasoned that "efficient" and "exciting" are adjectives foreign to the English language as a practical way of explaining causation.[87]

Although *Ledesma* was a products liability case, it should raise concerns for the commercial trial lawyer because the Texas Supreme Court indicated that it was not reluctant to find an abuse of discretion and reversible error even though the trial court submitted a pattern jury instruction on causation. The more significant issue that is raised in *Ledesma* is whether the Supreme Court's logic in changing the definition of producing cause would also apply to changing the definition of proximate cause. It could certainly be argued that the pattern definition of proximate causation is flawed for the same reasons the Texas Supreme Court held that the definition of producing cause is flawed. This is true because, like producing cause, the pattern instruction on proximate cause is very similar. Moreover, if "substantial factor" is now the test for producing cause it begs the question as to whether similar language will now apply to proximate cause.

The Texas Supreme Court's recent decision in *Wal-Mart Stores, Inc. v. Merrell*[88] redefines causation standards in tort cases contrary to the pattern instruction's definition that states there can be more than *one* proximate cause. In *Merrell*, Charles Merrell and Latosha Gibson (collectively, "Merrell") died from smoke inhalation while they slept in their rented home.[89] The Fire Department found candles, melted wax, an ashtray, as well as smoking paraphernalia throughout the house including a bong and marijuana cigarette butts.[90] "The fire marshal declared the fire accidental and of unknown origin."[91] Merrell's parents filed suit against Wal-Mart and alleged that a halogen lamp purchased from one of its stores caused the fire.[92]

Merrell's expert, Dr. Craig Beyler ("Dr. Beyler"), opined that the "nonpassive failure" of the lamp ignited the recliner.[93] It was Dr. Beyler's opinion that the halogen bulb exploded causing the fire.[94] The expert ruled out smoking materials as a cause because none were found in the immediate area of origin.[95] In contrast, Wal-Mart's expert opined that the more

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83 *Id*. at 45.

84 *Id*.

85 *Id.*

86 *Id.* (emphasis added) (citations omitted).

87 *Id*. at 46.

88 Wal-Mart Stores, Inc. v. Merrell, 313 S.W.3d 837 (Tex. 2010).

89 *Id.* at 838.

90 *Id.*

91 *Id.*

92 *Id.*

93 *Id.*

94 *Wal-Mart Stores, Inc.,* 313 S.W.3d at 383.

95 *Id.*

likely cause of the fire was careless disposal of smoking materials.[96] The trial court granted summary judgment. The Court of Appeals reversed and held fact issues precluded summary judgment. The Supreme Court granted a petition for review and reversed the Court of Appeals. The Texas Supreme Court held that Dr. Beyler's causation opinion was not evidence. *Merrell* reasoned that Dr. Beyler did not explain "why a burning cigarette could not have caused the fire."[97] According to the Supreme Court, Dr. Beyler improperly dismissed the post-mortem toxicology report that stated the deceased were smoking on the night of the fire.[98] *Merrell* held:

> Beyler did undertake to eliminate one potential cause of the fire that might otherwise seem on a par with the lamp theory. He explained why the melted candle wax and location of the candles precluded the candles as the source of the fire. Yet he provided no explanation for why lit smoking materials could not have been the source. *An expert's failure to explain or adequately disprove alternative theories of causation makes his or her own theory speculative and conclusory.* Most importantly, while Beyler laid a general foundation for the dangers of halogen lamps, his specific causation theory amounted to little more than speculation. Evidence that halogen lamps can cause fires generally does not establish that the lamp in question caused *this* fire.[99]

Merrell could be read to mean that tort plaintiffs must eliminate and adequately disprove alternative theories of causation in all tort cases. Although *Merrell* does not cite *Ledesma*, the Texas Supreme Court seems to be moving away from the language in the pattern instruction that specifically states there can be more than one proximate cause. It can certainly be argued that *Merrell* means that a plaintiff must prove the defendant's negligence was "the" cause rather than "a" cause. *Merrell* certainly puts a heightened onus of proof on causation standards in tort cases.

IV. RECOVERING ATTORNEY'S FEES IN A MIXED TORT/CONTRACT CASE. NEW AND EVER CHANGING RULES ON PREVAILING PARTIES, RECOVERY, PROOF, AND SEGREGATION OF FEES.

It is axiomatic that attorney's fees are recoverable only if authorized by a specific statute or if the party seeking relief recovers on a breach of contract claim.[100] Stated differently, attorney's fees are not recoverable in a tort action.[101] Issues as to whether an agreement or statute authorizes recovery of attorney's fees present questions of contract or statutory construction, and these generally are questions of law.[102]

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[96] *Id.*

[97] *Id.* at 839.

[98] *Id.*

[99] *Id.* at 839-840 (emphasis added) (citations omitted).

[100] Tony Gullo Motors I, L.P. v. Chapa, 212 S.W.3d 299, 311 (Tex. 2006); Travelers Indem. Co. of Conn. v. Mayfield, 923 S.W.2d 590, 594 (Tex. 1996); Wm. Cameron & Co. v. Am. Sur. Co. of N.Y., 55 S.W.2d 1032, 1035 (Tex. Comm'n App.1932, holding approved).

[101] Knebel v. Capital Nat'l Bank in Austin, 518 S.W.2d 795, 803-04 (Tex. 1974).

[102] Coker v. Coker, 650 S.W.2d 391, 394-95 (Tex. 1983) (explaining that courts construe unambiguous contracts and determine the existence of ambiguity as matters of law); New Amsterdam Cas. Co. v. Tex. Indus., Inc., 414 S.W.2d 914, 914-15 (Tex. 1967) (construing contract and statute as a matter of law to determine whether recovery of attorney's fees was authorized).

From 1991 to 2006, the exception to the fee-segregation rule applied "when the causes of action involved in the suit are dependent upon the same set of facts or circumstances and thus are intertwined to the point of being inseparable."[103] In light of the Texas Supreme Court's recent decision in *Chapa*, the factors that determine whether the fee-segregation exception rule applies changed.[104] After Chapa, the determination focuses upon the legal work performed that pertains solely to causes of action for which attorney's fees are not recoverable.[105] Under *Chapa*, the jury does not examine the work product in its entirety but must parse the work into separate tasks allocated to recoverable claims.[106] If any of the tasks at issue pertain solely to a claim for which legal fees are unrecoverable, the claimant must segregate the fees.[107] As articulated in Chapa, the question of the extent to which the exception to the fee segregation rule would apply presents a mixed question of law and fact:

> [T]he fees *necessary to prove particular* claims often turn on such facts-how hard something was to discover and prove, how strongly it supported particular inferences or conclusions, how much difference it might make to the verdict, and a host of other details that include judgment and credibility questions about who had to do what *and what it was worth.*[108]

Thus, Chapa requires the party seeking to recover attorney's fees "to segregate fees between claims for which they are recoverable and claims for which they are not."[109] However, the opposing party must preserve the contention that the party seeking affirmative relief failed to segregate the fees sought.[110] An exception exists to this general duty to segregate if the claims are inextricably intertwined.[111] To establish that attorney's fees are inextricably intertwined, the party seeking the recovery of attorney's fees must establish that discrete legal services advanced both a recoverable and an unrecoverable claim.[112]

Since *Chapa* was decided, there have been some new developments in the area of recovering attorney's fees. First, it is noteworthy that the Texas Supreme Court in *Medical City Dallas, LTD. v. Carlisle Corporation*[113] held that attorney's fees could be recovered for a breach of an express warranty.[114] Second, in *Varner v. Cardenas,*[115] the Texas Supreme Court

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[103] Stewart Title Guar. Co. v. Sterling, 822 S.W.2d 1, 11-12 (Tex. 1991) (quoting Gill Sav. Ass'n v. Chair King, Inc., 783 S.W.2d 674, 680 (Tex. App.—Houston [14th Dist.] 1989), *aff'd in part, modified in part,* 797 S.W.2d 31 (Tex. 1990) (per curiam).

[104] *See Chapa*, 212 S.W.3d at 311.

[105] *Id.*

[106] *Id*. at 313 ("But when Chapa's attorneys were drafting her pleadings or *the jury charge relating to fraud,* there is no question [that] those fees were not recoverable." (emphasis added)).

[107] 7979 Airport Garage, L.L.C. v. Dollar Rent A Car Sys., Inc., 245 S.W.3d 488, 509 (Tex. App.—Houston [14th Dist.] 2007, pet. denied).

[108] *Chapa*, 212 S.W.3d at 313 (emphasis added).

[109] *Id.* at 311 (citations omitted).

[110] Green Int'l, Inc. v. Solis, 951 S.W.2d 384, 389 (Tex. 1997).

[111] *Chapa,* 212 S.W.3d at 313.

[112] *Id.* at 313-14.

[113] Med. City Dall., Ltd. v. Carlisle Corp., 251 S.W.3d 55, 63 (Tex. 2008).

[114] *See id.* ("Because Texas Civil Practice and Remedies Code section 38.001(8) permits an award of attorney's fees for a suit based on a written or oral contract, and because we conclude that breach of an express warranty in such a claim, the court of appeals erred in reversing Medical City's attorney's fees award in connection with its successful claim for breach of an express warranty.").

[115] Varner v. Cardenas, 218 S.W.3d 68 (Tex. 2007).

held that in a breach of contract claim, the prevailing party could also recover attorney's fees in defending a counterclaim because the claimant had to respond to the counterclaim to prove their breach of contract case.[116] Third, in *AMX Enterprises, LLP v. Master Realty Corporation,*[117] the Court of Appeals, in an issue of first impression, held that in-house counsel could recover attorney's fees under a "market value" method.[118] Thus, in-house counsel can recover attorney's fees calculated at the market rate for outside counsel, even though the in house lawyers are salaried employees of the party appearing in the case.[119]

As recently as August 2010, the Texas Supreme Court decided two more companion cases that directly impact an award of attorney's fees. In *Intercontinental Group P'ship v. KB Homes Lone State L.P.*,[120] the issue before the Texas Supreme Court was whether a stand-alone finding of breach of contract with no award of actual damages made the non-breaching party a "prevailing party" that would trigger an award of attorney's fees under a mandatory provision in a contract.[121] In *Intercontinental*, the contract contained the following provision:

> ***Attorney's fees***. If either party named herein brings an action to enforce the terms of this Contract or to declare rights hereunder, the prevailing party in any such action, on trial or appeal, shall be entitled to his reasonable attorney's fees to be paid by losing party as fixed by the court.[122]
>
> Of note, "prevailing party" was not defined in the agreement.[123]

At trial, KB Home Lone Star, L.P. ("KB Home") received a jury finding that Intercontinental Group Partnership ("Intercontinental") breached the contract.[124] Although the jury awarded KB Homes $66,000 in attorney's fees, the jury awarded no actual damages stemming from that breach.[125] Meanwhile, the jury rejected Intercontinental's counter-claim.[126] Both parties claimed victory on the other's claims and argued that each were "prevailing parties" under the contract.

In an issue of first impression, the Texas Supreme Court adopted a "no-harm/no-fee" rule.[127] Rejecting the attorney fee claim, the Supreme Court held that "a stand-alone finding of breach unaccompanied by any tangible recovery (either monetary or equitable relief) cannot bestow 'prevailing party' status."[128] Thus, *Intercontinental* holds that to be a "prevailing party" under a mandatory attorney's fees provision, the party must be awarded actual damages or

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[116] *See id.* at 69 ("But we disagree that fees defending against the Cardenases' counterclaim must be segregated too. By asserting a shortfall in acreage as a defense and counterclaim, the Cardenases sought to reduce the amount collected on the note; to collect the full amount the Varners had to overcome this defense. As their attorney's fees to that effect were necessary to recover on their contract, they are recoverable.") (citations omitted).

[117] AMX Enters., L.L.P. v. Master Realty Corp., 283 S.W.3d 506 (Tex. App.—Fort Worth 2009, no pet.)

[118] *Id.* at 519.

[119] *Id.*

[120] Intercontinental Grp. P'ship v. KB Homes Lone Star L.P., 295 S.W.3d 650 (Tex. 2009).

[121] *Id.* at 653.

[122] *Id.* at 652.

[123] *Id.*

[124] *Id.*

[125] *Id.*

[126] *Id.*

[127] *Id.* at 662.

[128] *Id.*

some form of equitable relief such as specific performance, a declaratory judgment, or injunctive relief. In so far as K.B. Homes' attorney's fees claim is concerned, the Texas Supreme Court held that error was waived because K.B. Homes did not submit an attorney's fees claim to the jury. It is important to note that *Intercontinental* also holds that the parties could have defined "prevailing party" in terms that are either narrower or stricter than the law provides for the recovery of attorney's fees.

On the same day the Texas Supreme Court issued its opinion in *Intercontinental*, it also decided a similar attorney's fees claim in *MBM Financial Corp. v. Woodlands Operating Company,*[129] *In MBM Financial Corp*, the Woodlands Operating Company ("Woodlands") leased 19 copiers from MBM Financial Corporation ("MBM"), and a separate four-year lease covered each copier.[130] According to the leases, the agreements automatically renewed unless there was written notice provided between 90 and 180 days before the expiration of the lease term.[131] The Woodlands opted not to renew the leases and requested from MBM end-of-term dates and instructions for return.[132] MBM provided the dates and approved a draft termination letter provided by the Woodlands.[133] However, when the actual termination letter arrived, MBM's president unilaterally changed the dates so the notice would be untimely and demanded rent for another year.[134] To bolster MBM's position, the president then signed the leases and inserted commencement dates for the first time after the Woodland's filed suit.[135] Until suit was filed MBM refused to designate a return location for the copiers.[136]

The Woodlands sought declaratory relief and brought claims for breach of contract and fraud.[137] MBM counter-claimed and sought additional rent of $160,000.[138] After a two day bench trial, the trial court awarded the Woodlands $1,000 in damages and over $145,000 in attorney's fees through trial. The Court of Appeals affirmed. The Texas Supreme Court reversed. Justice Brister opined that the Woodlands requested only nominal damages and, furthermore, there was no evidence to support the award of $1,000 in actual damages.[139] Because there was no evidence of actual damages, the Court held that an award of attorney's fees could not be affirmed on that basis.[140]

The Woodlands countered and argued that the trial court granted declaratory relief and, therefore, attorney's fees are appropriate under the Declaratory Judgment Act.[141] Rejecting this argument, the Texas Supreme Court held that allowing the Woodlands to recover attorney's fees under the Declaratory Judgments Act (Chapter 37), when it could not have recovered attorney's fees under the Attorney's Fees Statute (Chapter 38), would frustrate the provisions and limitations of the neighboring chapter in the same code.[142] Nevertheless, the

[129] MBM Fin. Corp. v. Woodlands Operating Co., L.P., 292 S.W.3d 660 (Tex. 2009).

[130] *Id.* at 663.

[131] *Id.*

[132] *Id.*

[133] *Id.*

[134] *Id.*

[135] *MBM Fin. Corp.*, 292 S.W.3d at 663.

[136] *Id.*

[137] *Id.*

[138] *Id.*

[139] *Id.*

[140] *Id.*

[141] *MBM Fin. Corp.*, 292 S.W.3d at 663; *see* TEX. CIV. PRAC. & REM. CODE § 37.009 (Vernon Supp. 1986).

[142] *MBM Fin. Corp.*, 292 S.W.3d at 670.

Woodlands argued that there were five separate issues that it prevailed upon in its application for a declaratory judgment. However, Justice Brister opined that these same points of relief were part and parcel of the Woodlands' breach of contract claim upon which there was no evidence of damages. Accordingly, the Court held that attorney's fees were inappropriate under either statute.[143]

Finally, in *Midland Western Building L.L.C. v. First Service Air Conditioning Contractors, Inc.*,[144] First Service Air Conditioning Contractors, Inc. ("First Service") sued Midland Western Building, LLC ("Midland") on a $21,693.56 sworn account for failing to pay under a services agreement and sought to recover its attorney's fees.[145] At trial, First Service's attorney testified that between $24,000 and $26,000 would be a reasonable attorney's fee. The jury awarded First Service $14,645.10 in damages but awarded no attorney's fees.[146] The Court of Appeals reversed and awarded attorney's fees because there was no controverting evidence offered and First Service was entitled to fees.[147] The Texas Supreme Court reversed the Court of Appeals.[148]

Midland reasoned that First Service's attorney admitted that some of the fees sought involved claims against parties other than the defendant. Thus, fees could not be awarded as a matter of law, but the Court held that an award of zero fees was improper.[149] While the jury could have concluded that a lesser fee was appropriate, an award of zero fees was inappropriate because fees were necessary to prove the claim.[150] Thus, the Supreme Court remanded for a new trial on attorney's fees.[151]

V. CAPPING THE UNLIMITED CAPS: NEW DEVELOPMENTS IN EXEMPLARY DAMAGES IN BUSINESS TORT CASES. A LOOK AT *BENNETT V. REYNOLDS*, NO. 08-0074, 2010 WL 2541096 (TEX. JUNE 25, 2010), WHICH SET ASIDE A CAP BUSTING FINDING ON EXEMPLARY DAMAGES AND HELD THAT A RATIO ANALYSIS BETWEEN ACTUAL AND EXEMPLARY DAMAGES APPLIES UNDER A CONSTITUTIONAL ANALYSIS REGARDLESS OF A CAP BUSTING FINDING

Some cases have held that if plead, submitted to the jury, and proven based upon a unanimous finding, certain criminal offenses may remove the statutory cap on exemplary damages in civil cases.[152] For example, in a fraud dispute, if the jury found that the defendant secured the execution of documents by deception (a felony), there would be no legislative cap on

[143] *Id.* at 670.

[144] Midland W. Bldg. L.L.C. v. First Serv. Air Conditioning Contractors, Inc., 300 S.W.3d 738 (Tex. 2009).

[145] *Id.* at 739.

[146] *Id.*

[147] *Id.* at 739.

[148] *Id.* at 740.

[149] *Id.*

[150] *Midland*, 300 S.W.3d at 740.

[151] *Id.*

[152] *See* TEX. CIV. PRAC. & REM. CODE ANN. § 41.008 (Vernon 2003); *see, e.g.,* Signal Peak of Enters., Inc. v. Bettina Invs., Inc., 138 S.W.3d 915, 927 (Tex. App.—Dallas 2004, pet. struck); Poliner v. Tex. Health Sys., 239 F.R.D. 468, 477 (N.D. Tex. 2006) (Solis, J.) (rev'd on other grounds) 537 F.3d 368 (5th Cir. 2008), *cert. denied*, 129 S. Ct. 1002 (2009); *see also* Myers v. Walker, 61 S.W.3d 722, 732 (Tex. App.—Eastland 2001, pet. denied) (no cap on punitive damages and affirming award of exemplary damages where documents were executed by deception).

an award of exemplary damages that were found in excess of the cap.[153] Similarly, if a jury found murder in a wrongful death case, there would be no cap on exemplary damages.[154]

Texas courts had previously noted that both constitutional and cap limitations on exemplary damages were inapplicable when the jury makes a cap-busting finding.[155] The legislature has voiced a policy intention to make certain crimes, such as executing documents by deception, murder, kidnapping, and sexual assault to name a few, as worse offenses than others.

However, in *Bennett v. Reynolds,* the court effectively repealed those Chapter 41 crimes that removed the caps on exemplary damages.[156] In *Bennett*, Thomas Bennett ("Bennett") became embroiled in a cattle feud with his neighbor, Randy Reynolds ("Reynolds").[157] After prevailing in a small claims dispute over reconstructing a fence the two parties shared, Reynolds mentioned in the courtroom to Bennett that he was missing some cattle and inquired as to whether Bennett had seen them.[158] Bennett immediately went to the Sheriff's office and accused Reynolds of stealing *his* cattle.[159] Bennett had stolen thirteen head of cattle, while knowing those cattle belonged to Reynolds.[160] Both of Bennett's ranch hands raised concerns that Bennett did not actually own the cattle.

One of Bennett's ranch hands, Larry Grant ("Grant"), told Reynolds that Bennett had stolen his cattle.[161] While driving to the auction, Grant photographed the cattle showing Reynolds Reynolds' registered brand.[162] When Bennett discovered Grant had incriminating evidence, Bennett encouraged Grant to lie, and Bennett later offered Grant a lucrative job.[163] When Grant refused, one of Bennett's ranch hands attempted to threaten Grant with bodily injury but mistakenly made the threat to Grant's brother-in-law.[164] Bennett then filed a slander suit against Grant to intimidate him.[165] Bennett even attempted to register Reynolds' brand so that he could cover up the theft.[166] There were also allegations that Bennett tampered with the photographs to bolster his defense.[167] Bennett was indicted for cattle theft but acquitted.

The civil trial proceeded to a jury verdict that resulted in an award of $5,327.11 in actual damages for the cattle and $1.25 million in combined uncapped exemplary damages for felony theft against Bennett and his corporation. The Court of Appeals affirmed the uncapped

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[153] *See, e.g.*, TEX. CIV. PRAC. & REM. CODE § 41.008 (11) (Vernon 2003).

[154] *See id.* at § 41.008.

[155] *Compare* Bennett v. Reynolds, 242 S.W.3d 866, 901-05 (Tex. App.—Austin 2007) *rev'd*, 315 S.W.3d 867 (Tex. 2010) (exemplary damages award of $1,000,000 did not violate due process because the jury found felony theft, which is a cap buster, even though the actual damages awarded was only slightly more than $5,000.); *Myers*, 61 S.W.3d at 732-33 (where attorney secured the execution of a settlement agreement by deception the caps on exemplary damages did not apply following bench trial on the merits).

[156] *Bennett v. Reynolds,* 315 S.W.3d at 869.

[157] *Id.* at. 869.

[158] *Id.* at 870.

[159] *Id.*

[160] *Id.*

[161] *Id.*

[162] *Bennett*, 315 S.W.3d at 870.

[163] *Id.* at 875.

[164] *Id.* at 876.

[165] *Id.*

[166] *Id.* at 877.

[167] *Bennett*, 315 S.W.3d at 876.

exemplary damages. The Texas Supreme Court reversed and held that uncapped exemplary damages are subject to a constitutional ratio analysis between actual and exemplary damages. *Bennett* held that any ratio above 4:1 "might be close to the line of constitutional impropriety."[168] In fact, the Supreme Court stated that an award of 4.33 times actual damages is constitutionally excessive but cautioned that a rigid 4:1 ratio is not universally required. [169]

In determining what ratio might apply, the Texas Supreme Court adopted five "reprehensibility" factors from the United States Supreme Court's decision in *BMW of North America, Inc. v. Gore*,[170] which include the following:

1. the harm inflicted was physical rather than economic;
2. the tortious conduct showed an indifference to or a reckless disregard for the health or safety of others;
3. the target of the conduct had financial vulnerability;
4. the conduct involved repeated actions, not just an isolated incident; and
5. the harm resulted from intentional malice, trickery, or deceit, as opposed to mere accident.[171]

The Supreme Court remanded an appropriate exemplary damage award to the Court of Appeals, but stated that a 4:1 ratio in this case with no physical injury would be a stretch.[172] *Bennett* held:

> Our settled practice is not to remit unconstitutional awards ourselves or to prescribe a required ratio, though on this record, even 4:1 seems a stretch: 'Pushing exemplary damages to the absolute constitutional limit in a case like this leaves no room for greater punishment in cases involving death, grievous physical injury, financial ruin, or actions that endanger a large segment of the public . . . The Supreme Court is decidedly hands-on when scrutinizing high-dollar exemplary-damages awards, and we are confident the Court would conclude this award 'was neither reasonable nor proportionate to the wrong committed, and it was an irrational and arbitrary deprivation of the property of the defendant.'[173]

In light of the standards set forth in *Bennett*, the cap busters on exemplary damages are judicially repealed because every exemplary damages award is subject to a 4:1 actual-to-exemplary damages ratio or less under this holding. The irony of *Bennett* is that instead of receiving uncapped exemplary damages of $1.25 million, the plaintiff is probably not even entitled to approximately $20,000 in exemplary damages on remand [$5,327.11 (actual damages) x. 4 (a stretch) = $21,308.44]. If the statutory cap on exemplary damages had been applied, Reynolds would have at least received the statutory minimum of $200,000. Thus, the Supreme Court's application of due process limitations lowers the exemplary damages to less than one-tenth of the legislative cap, which the jury removed in its entirety by its finding of felony theft. *Bennett* now caps all exemplary damages regardless of the application of the unlimited caps and would suggest to trial courts that the best ratio a plaintiff could ever obtain is 4:1.

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[168] *Id*. at 877 (citations omitted).

[169] *Id.* at 878-79.

[170] BMW of North America, Inc. v. Gore, 517 U.S. 559, 575-76 (U.S. 1996).

[171] *See Bennett*, 315 S.W.3d at 874 (citations omitted).

[172] *Id.* at 885.

[173] *Id.* at 882-883 (citations omitted).

VI. SETTLEMENT AGREEMENTS REACHED DURING JURY DELIBERATIONS. A BRAND NEW DECISION FROM THE TEXAS SUPREME COURT MAY CHANGE HOW RULE 11 SETTLEMENTS ARE ENFORCED DURING TRIAL. *FORD MOTOR CO. V. CASTILLO*, 279 S.W.3D 656 (TEX. 2009)

In *Ford Motor Co. v. Castillo*,[174] Ford Motor Company ("Ford") and Ezequiel Castillo ("Castillo") settled their lawsuit while the jury was deliberating.[175] The settlement occurred after the presiding juror sent a note to the judge asking the maximum amount that could be awarded.[176] Based on later discussions with jurors, Ford suspected that outside influence may have been brought to bear upon the presiding juror.[177] After Ford sought, but was refused permission, to obtain discovery on the outside influence question, it withdrew its consent to the settlement.[178] The trial court granted summary judgment in Castillo's favor on the breach of settlement claim.[179] The Texas Supreme Court reversed and held that Ford was entitled to discovery on the breach of contract claim.[180]

In *Castillo*, the Supreme Court held that when consent is withdrawn the agreed judgment that was part of the settlement may not be entered; rather, the Court held that the party seeking enforcement of the settlement agreement must pursue a separate claim for breach of contract.[181] *Castillo* further held that because a breach of a settlement agreement is a separate case from the underlying lawsuit discovery is permitted on the claim.[182] The Texas Supreme Court also held that the "validity of a settlement agreement cannot be determined without full resolution of the surrounding facts and circumstances."[183] The Texas Supreme Court reasoned that "the rules specifically allow jurors to testify about outside influence brought to bear on any of them."[184] Lastly, *Castillo* held that it was harmful error by denying Ford the opportunity to conduct discovery on Castillo's claim for breach of the settlement agreement.[185]

As this paper illustrates, the Texas Supreme Court has trended toward enforcing agreements, especially contracts executed at arms-length with independent counsel. In contrast to the cases cited above, *Castillo* seems to buck that trend, providing an avenue for lawyers to bust settlement agreements and potentially examine jurors about the meaning of their notes to the judge in jury deliberations where, as here, a settlement is reached based upon an interpretation of such a note.

It will be interesting to see if *Castillo* leads to a future problem in enforcing settlement agreements when parties withdraw their consent. *Castillo* also begs the question that if the plaintiff's attorney had placed a waiver-of-reliance provision in the Rule 11 settlement

[174] Ford Motor Co. v. Castillo, 279 S.W.3d 656 (Tex. 2009).
[175] *Id.* at 659.
[176] *Id.*
[177] *Id.*
[178] *Id.*
[179] *Id.*
[180] *Ford*, 279 S.W.3d at 659.
[181] *Id.* at 663 (citations omitted).
[182] *Id.*
[183] *Id.* (quotations omitted).
[184] *Id.* at 666 (citing TEX. R. CIV. P. 327(b)).
[185] *Id.* at 667.

agreement, would that have precluded Ford from arguing on appeal that it was somehow relying on the juror's comment in settling the underlying case? However, we do not know whether this was addressed or not because the precise language of the Rule 11 agreement in *Castillo* is not contained in the opinion and this point of error were was not raised on appeal. *Castillo*, would certainly imply that lawyers should place waiver-of-reliance provisions in their settlement agreements.

VII. AN UPDATE ON FORUM SELECTION CLAUSES. ARE THEY BECOMING MORE CLOSELY SCRUTINIZED IN THE COURTS OF APPEAL AND IS MANDAMUS A REMEDY? *IN RE INTERNATIONAL PROFIT ASSOCIATES, INC.*, 274 S.W.3D 672 (TEX. 2009), *IN RE ADM INVESTOR SERVICES, INC.*, 304 S.W.3D 371 (TEX. FEB. 19, 2010), AND *QUIXTAR INC. V. SIGNATURE MANAGEMENT TEAM*, LLC, NO. 09-0345, 2010 WL 2635985 (TEX. JULY 2, 2010)

Forum-selection clauses are generally enforceable, and a party attempting to show that such a clause should not be enforced bears a heavy burden.[186] A trial court abuses its discretion if it refuses to enforce a forum-selection clause unless the party opposing enforcement clearly shows that: (1) the clause is invalid for reasons of fraud or overreaching, (2) enforcement would be unreasonable or unjust, (3) enforcement would contravene a strong public policy of the forum where the suit was brought or (4) the selected forum would be seriously inconvenient for trial.[187] Mandamus relief is available to enforce forum-selection agreements because there is no adequate remedy by appeal when a trial court abuses its discretion by refusing to enforce a valid forum-selection clause that covers the dispute.[188]

In *In re International Profit Associates*,[189] the Texas Supreme Court granted mandamus relief, reversed the Corpus Christi Court of Appeals, and held that a forum selection clause was enforceable. In *International Profit*, McAllen Tropicpak ("Tropicpak") entered into separate contracts with International Profit Associates, Inc. and three related management and tax consulting firms (collectively, "IPA").[190] The contracts provided that IPA would provide, *inter alia*, general business consulting services to Tropicpak.[191] In each of the agreements, there was the following paragraph: "It is agreed that exclusive jurisdiction and venue shall vest in the Nineteenth Judicial District of Lake County, Illinois, Illinois law applying."[192] According to Tropicpak, IPA made business recommendations, including that Tropicpak hire David Salinas to help boost sales.[193] Tropicpak hired Salinas, who embezzled large sums of money from the company.[194] Tropicpak sued Salinas and IPA; the latter was sued for fraud, negligence, and negligent hiring and retention.[195] IPA moved to dismiss the suit based upon the forum-selection clause; thereafter, the trial court denied the motion and the Court of Appeals af-

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[186] *In re* Lyon Fin. Servs., Inc., 257 S.W.3d 228, 232 (Tex. 2008) (per curiam) (citing *In re* AIU Ins. Co., 148 S.W.3d 109, 113 (Tex. 2004)).

[187] *Lyon,* 257 S.W.3d at 231-232; *AIU*, 148 S.W.3d at 112; *see also* M/S Bremen v. Zapata Off-Shore Co., 407 U.S. 1, 15-17 (1972).

[188] *Lyon*, 257 S.W.3d at 231; *AIU*, 148 S.W.3d at 115-20.

[189] *In re* Int'l Profit Assocs., 274 S.W.3d 672 (Tex. 2009).

[190] *Id.* at 674.

[191] *Id.*

[192] *Id.*

[193] *Id.*

[194] *Id.*

[195] *International Profit Associates*, 274 S.W.3d at 674-75.

firmed in an unpublished opinion.

Reversing the Court of Appeals, *International Profit* reasoned, in part, that forum selection clauses are analogous to arbitration provisions.[196] It was Tropicpak's contention, *inter alia*, that the claims being asserted were outside the scope of the contracts because none of the contracts called for IPA to make employment recommendations.[197] Rejecting this argument, *International Profit* held that "[b]y agreeing to the forum-selection clauses, Tropicpak represented to IPA that the agreed forum would not be so inconvenient that enforcing the clause would deprive Tropicpak of its day in court."[198]

The Texas Supreme Court stated that Tropicpak failed to prove that special and unusual circumstances developed after the contracts were executed and that litigation in Illinois would be so "gravely difficult and inconvenient" that Tropicpak for practical purposes would be deprived of its day in court.[199] Thus, Tropicpak failed to rebut the presumption that the clause was valid; and further, it failed to show that the claims fell within the scope of the clause.[200] Accordingly, the Supreme Court granted mandamus relief ordering the trial court to dismiss the case.

Similarly, in *In re ADM Investor Services, Inc*,[201] Jetta Prescott ("Prescott") executed an agreement with ADM to trade commodities on Prescott's behalf.[202] When Prescott's balance reached a deficit in excess of $50,000, ADM was authorized to close her account and collect the deficit from Texas Trading.[203] Prescott's balance reached a deficit of $57,844.29.[204] ADM closed her account and collected the deficit from Texas Trading's CEO, Charles Dawson.[205] Dawson sued Prescott and obtained a judgment against her.[206] Prescott then sued Texas Trading and ADM alleging fraud, negligence, and breach of fiduciary duty.[207] ADM moved to dismiss pursuant to a contractual forum selection clause.[208]

Prescott argued that ADM waived enforcement by waiting three months to seek dismissal.[209] The Texas Supreme Court granted mandamus relief and dismissed the case against ADM.[210] In *ADM,* the court stated that there is a strong presumption against waiver.[211] The Court noted that "merely participating in litigation does not categorically mean the party has invoked the judicial process so as to waive enforcement."[212] The court stated "the burden of

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196 *Id.* at 677.

197 *Id.* at 678.

198 *Id.* at 680 (citations omitted).

199 *Id.* (citations omitted).

200 *Id.*

201 *In re* ADM Investor Servs., Inc., 304 S.W.3d 371 (Tex. 2010).

202 *Id.* at 373.

203 *Id.*

204 *Id.*

205 *Id.*

206 *Id.*

207 *ADM*, 304 S.W.3d at 373.

208 *Id.*

209 *Id.*

210 *Id.*

211 *Id.* at 374.

212 *Id.* (citing *AIU*, 148 S.W.3d at 113).

proof is *heavy* for the party challenging enforcement."[213] Prescott was nearing 80 years of age and presented proof that her health would prohibit her from pursuing litigation in two different states.[214] The Texas Supreme Court rejected this argument. *ADM* held:

> We conclude that Prescott did not overcome the presumption against ADM's waiving its right to enforce the forum selection clause by showing that ADM substantially invoked the judicial process. We also conclude that Prescott failed to satisfy her burden to demonstrate that enforcement of the forum selection clause would be unjust and unreasonable. Accordingly, we hold that the trial court abused its discretion in denying ADM's motion to dismiss. There is no adequate remedy by appeal when a trial court refuses to enforce a forum selection clause.[215]

Parties whose agreements contain forum selection clauses can assume that the Texas Supreme Court will expect those contractual provisions to be enforced even when there is an independent tort that is being asserted outside the agreement itself and even if enforcement would result in multiple suits in different forums. It is also important to note that, akin to forum selection clauses, the Texas Supreme Court has modified the forum non-conveniens analysis to provide the trial court with more flexibility and deference in dismissing cases that may or may not be inappropriately filed in Texas.

In *Quixtar Inc. v. Signature Management Team, LLC*, a dispute arose between Quixtar, Inc. ("Quixtar") and Signature Management Team, LLC ("Team").[216] Quixtar is a Virginia corporation with its principal place of business in Michigan.[217] Team is an LLC organized in Nevada with its principal place of business in Michigan.[218] Quixtar alleged that Team taught its individual business owners improper and potentially illegal business-building techniques that put Quixtar's entire business at risk.[219] Team filed suit in Collin County.[220] The trial court dismissed the case based upon forum non-conveniens.[221] The Court of Appeals reversed the trial court.[222] The Texas Supreme Court reversed the Court of Appeals and held the trial court did not abuse its discretion in dismissing the case.[223]

"A defendant seeking forum non-conveniens dismissal ordinarily bears a heavy burden in opposing the plaintiff's chosen forum."[224] However, there is substantially less deference to a non-resident's choice of forum.[225] Team argued that its individual business owner affiliates are located in Texas.[226] Nevertheless, the Texas Supreme Court held that Team was

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213 *ADM*, 304 S.W.3d at 375.

214 *Id.*

215 *Id.* at 376.

216 Quixtar Inc. v. Signature Mgmt. Team, L.L.C., 315 S.W.3d 28, 30 (Tex. 2010).

217 *Id.*

218 *Id.*

219 *Id.*

220 *Id.*

221 *Id.* at 31.

222 *Quixstar,* 315 S.W.3d at 31.

223 *Id.* at 35.

224 *Id.* at 31.

225 *Id.*

226 *Id.* at 33.

not a Texas resident; and, therefore, it was entitled to less deference than a Texas resident.[227] The Court followed *Gulf Oil Corp. v. Gilbert*[228] and noted that the central focus of the analysis is convenience.[229]

Private considerations under *Gulf Oil* include the following:

> (1) the relative ease of access to sources of proof;
> (2) the availability of compulsory process for attendance of unwilling and the cost of obtaining attendance of willing witnesses;
> (3) the possibility to view the premises if view would be appropriate;
> (4) the enforceability of a judgment;
> (5) all other practical problems that make trial of a case easy, expeditious, and inexpensive.[230]

Public considerations include the following:

> (1) administrative difficulties … for courts when litigation in congested centers, rather than being handled at its origin;
> (2) the burden of jury duty upon a community that may have no relation to the litigation;
> (3) local interest in having local controversies decided at home; and
> (4) avoiding conflicts of law issues.[231]

Upon applying these factors, the Supreme Court held there was no abuse of discretion in dismissing the case on the basis of forum non-conveniens.[232] The Court stated that forum non-conveniens dismissals are within the sound discretion of the trial court and involve weighing various factors that may be difficult to quantify. Accordingly, the Court held the dismissal was appropriate and refused to employ a formulaic standard for evaluating the trial court's ruling.

VIII. AN UPDATE ON NEW CASE LAW FROM THE SUPREME COURT ON ARBITRATION CLAUSES. IS THE TEXAS SUPREME COURT NOW EXPANDING THE SCOPE AND BREADTH OF TRADITIONAL ARBITRATION CLAUSES BY ENFORCING THOSE PROVISIONS AGAINST NON-SIGNATORIES TO THE AGREEMENT? *IN RE LABATT FOOD SERVICE, L.P.*, 279 S.W.3D 640 (TEX. 2009) AND *IN RE JINDAL SAW LIMITED, LLC*, 289 S.W.3D 827 (TEX. 2009).

There are two recent Texas Supreme Court decisions that expand the scope and the enforceability of arbitration clauses to non-signatories of such agreements.[233]

In *In re Labatt Food Service, L.P.*, the issue facing the Texas Supreme Court was whether wrongful death beneficiaries are bound by their decedent's pre-death contractual

[227] *Id.*

[228] Gulf Oil Corp. v. Gilbert, 330 U.S. 501, 508 (1947).

[229] *See Quixtar*, 315 S.W.3d at 33.

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

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

[232] *Id.* at 35.

[233] *Compare In re* Labatt Food Serv., L.P., 279 S.W.3d 640 (Tex. 2009), *reh'g denied* (May 1, 2009), with, *In re* Jindal Saw, Ltd., 289 S.W.3d 827 (Tex. 2009).

agreement to arbitrate any claims.[234] Labatt Food Service, L.P. ("Labatt") was a non-subscriber to the Texas Workers' Compensation system.[235] It provided an occupational injury plan under which its employees could elect to participate.[236] In order to become participants in the plan, employees were required to sign an agreement entitled "Election of Comprehensive Benefits, Indemnity, and Arbitration Agreement."[237] Under the plan, the employee elects to be covered under the plan and individually and on behalf of his heirs and beneficiaries.[238]

Carlos Dancy, Jr. ("Dancy"), a Labatt employee, elected to participate in the plan and signed an agreement.[239] Dancy later died from an asthma attack that occurred during the course and scope of his employment.[240] Dancy's parents and children filed a wrongful death suit.[241] Labatt moved to compel arbitration.[242] In opposition to arbitration, Dancy's beneficiaries argued that (1) they were not signatories to the agreement, and (2) the agreement was void because the indemnity clause was a pre-injury waiver in violation of the Texas Labor Code.[243] In response, Labatt argued that the beneficiaries are bound by the agreement because they are third party beneficiaries, the claims are derivative, and the Texas Family Code provided Dancy with the authority to bind his children.[244] T he trial court denied the motion. The Court of Appeals denied mandamus. The Texas Supreme Court reversed, granted mandamus relief, and ordered the parties to arbitration. *Labatt* held:

> While it is true that damages for a wrongful death action are for the exclusive benefit of the beneficiaries and are meant to compensate them for their own personal loss, the cause of action is still entirely derivative of the decedent's rights. Thus, regardless of the fact that Dancy's beneficiaries are seeking compensation for their own personal loss, they still stand in Dancy's legal shoes and are bound by his agreement.[245]

With respect to Labatt's claim that the agreement was unenforceable as an improper pre-injury release, the Texas Supreme Court refused to address that question holding instead that it was an issue for the arbitrator.[246] Because Dancy would have been forced to arbitrate his personal injury claim, the Texas Supreme Court held that his beneficiaries were similarly required to arbitrate.[247]

Similarly, in *In re Jindal Saw Limited*,[248] "Saw Pipes USA, Inc. ("Saw Pipes") did not provide workers' compensation insurance to cover its employees in the event of an on-the-job

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[234] *See Labatt*, 279 S.W.3d at 642.
[235] *Id.*
[236] *Id.*
[237] *Id.*
[238] *Id.*
[239] *Id.*
[240] *Labatt*, 279 S.W.3d at 642.
[241] *Id.*
[242] *Id.*
[243] *Id.*
[244] *Id.*
[245] *Id.* at 646.
[246] *Labatt*, 279 S.W.3d at 649.
[247] *Id.*
[248] *Jindal Saw*, 289 S.W.3d at 827.

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injury.[249] Rather, it provided an employee benefit plan and its employees could elect to participate.[250] Attached to the plan was an agreement to arbitrate.[251] Carlos Lara ("Lara"), a Saw Pipes employee, elected to participate in the agreement and signed the plan.[252] Lara died from injuries that occurred during the course and scope of his employment.[253] His wife and children filed a wrongful death and survival action.[254] Saw Pipes filed a motion to compel arbitration.[255] The trial court denied the Motion.[256] The Texas Supreme Court reversed and granted mandamus relief relying upon *Labatt*. *Jindal Saw* held:

> In *Labatt*, we held that a decedent's pre-death arbitration agreement binds his or her wrongful death beneficiaries because under Texas law the wrongful death cause of action is entirely derivative of the decedent's rights.[257]

Labatt and *Jindal Saw* underscore the trend in the Texas Supreme Court to broadly enforce agreements to arbitrate even when such agreements bind non-signatories and even when the agreement is signed pre-death. These decisions are consistent with a recurring theme that the Texas Supreme Court will bend over backwards to enforce the parties' agreement even if it prejudices parties that neither signed nor participated in the negotiations to the agreement at issue.

IX. AN UPDATE ON SUBROGATION AND WORKERS' COMPENSATION LIENS. ARE ATTORNEYS NOW PERSONALLY ON THE HOOK FOR FAILING TO HONOR A LIEN? A NEW CLAIM FOR CONVERSION AND DISGORGEMENT. *TEXAS MUTUAL INSURANCE CO. V. LEDBETTER*, 251 S.W.3D 31 (TEX. 2008).

A recent case from the Texas Supreme Court in the area of workers' compensation liens creates, or at least better defines, a new business tort against attorneys for conversion and disgorgement of settlement funds where the settlement is designed to circumvent either a carrier's lien or its right to subrogation.

In *Texas Mutual Insurance Co. v. Ledbetter*,[258] Charles Ledbetter ("Ledbetter") was electrocuted during the course and scope of his employment.[259] Ledbetter's workers' compensation carrier, Texas Mutual Insurance Company ("Texas Mutual"), paid funeral expenses and began paying monthly death benefits to his widow and minor son.[260] Ledbetter's widow, his minor son, and his adult daughters filed a third party liability claim against the parties that were responsible for his death.[261] The case settled for $4.5 million.[262] The settlement was

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[249] *Id.*

[250] *Id.*

[251] *Id.*

[252] *Id.*

[253] *Id.*

[254] *Jindal Saw*, 289 S.W.3d at 827.

[255] *Id.*

[256] *Id.*

[257] *Id.* at 828.

[258] Tex. Mut. Ins. Co. v. Ledbetter, 251 S.W.3d 31 (Tex. 2008).

[259] *Id.* at 33.

[260] *Id.* at 34.

[261] *Id.*

made only two weeks before the trial setting.[263] An ad litem was appointed to approve the settlement.[264] Before the minor prove up, Texas Mutual intervened.[265] At the start of the hearing, the plaintiff's attorney non-suited all claims except those of the estate.[266] The trial court, over Texas Mutual's objection, granted the non-suit.[267] The plaintiffs then announced that the settlement would be allocated to Ledbetter's estate, to the plaintiff's attorney, and there would be no proceeds to the widow, minor child, or the adult daughters.[268] The trial court approved the settlement.[269]

The Texas Supreme Court held that a workers' compensation carrier has a mandatory right to first money and a plaintiff cannot non-suit a claim that would prejudice the carrier's rights to either a lien or subrogation.[270] Of importance here, *Ledbetter* specifically held that the workers' compensation insurance carrier had a cause of action for conversion against the plaintiffs, the plaintiff's attorney, and the defendants and that the remedy against the plaintiffs and the plaintiff's attorney is disgorgement.[271] *Ledbetter* held:

> When an injured worker settles a case without reimbursing a compensation carrier, everyone involved is liable to the carrier for conversion – the plaintiffs, the plaintiffs' attorney, and the defendants. As between those parties, we have held that generally those who received the funds unlawfully (the plaintiffs and their attorney) should disgorge them rather than making the tortfeasors pay twice.[272]

Ledbetter is one of the most aggressive opinions nationwide in protecting workers' compensation insurance carrier's lien against a personal injury settlement. In light of *Ledbetter*, the plaintiff's attorney cannot even non-suit claims anymore without the consent of the carrier; and, furthermore, because the carrier is entitled to first money under all circumstances it makes the plaintiff's attorney a lawyer for the carrier as much as his own client. But the question remains, if the plaintiff's lawyer is retained only to represent the estate's claim, can the compensation carrier nevertheless intervene to claim first money or will the carrier be forced to expend its own proceeds and file a separate claim for subrogation against the same third parties.

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[262] *Id.*

[263] *Id.*

[264] *Tex. Mut. Ins.*, 251 S.W.3d at 34.

[265] *Id.*

[266] *Id.*

[267] *Id.*

[268] *Id.*

[269] *Id.*

[270] *See Tex. Mut. Ins.*, 251 S.W.3d at 38 ("Rule 162 is not limited to affirmative claims against the nonsuiter; it prohibits dismissal if the effect would be to prejudice any pending claim for affirmative relief, period.").

[271] *Id.* at 38-39.

[272] *Id.*

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X. AN UPDATE ON FIRST PARTY INSURANCE CASES. CAN AN INSURANCE CARRIER AVOID LIABILITY, STATUTORY PENALTIES, AND EXTRA-CONTRACTUAL DAMAGES BY INTERPLEADING THE DISPUTED FUNDS? A NEW SUPREME COURT CASE IN *STATE FARM LIFE INSURANCE CO. V. MARTINEZ*, 216 S.W.3D 799 (TEX. 2007)

In interpreting the 1991 changes to the Insurance Code, the Texas Supreme Court recently held that an insurer who interpleads policy proceeds cannot be subject to statutory penalties for delayed payments after interpleader occurs. In *State Farm Life Insurance Co. v. Martinez*,[273] Ed and Linda Martinez divorced and Ed agreed to pay Linda contractual alimony for a period of ten years, with his estate to continue paying if he died earlier.[274] Ed also agreed to name Linda as an irrevocable beneficiary on three life insurance policies, providing that he could drop those policies as long as the total amount of unpaid alimony was recovered.[275]

At issue in this case is a $500,000 policy issued by State Farm.[276] In 1994, Ed listed his ex-wife as the beneficiary per the divorce decree.[277] However, shortly before his death, Ed signed a change of beneficiary form designating his current wife as the beneficiary.[278] State Farm refused to process the request requiring proof that the change complied with the divorce agreement.[279] Ed died days after signing the request and before he could act on State Farm's response.[280] Upon death, State Farm received conflicting claims from Ed's daughter, Linda, and his current wife.[281] Two days later, State Farm filed an interpleader and deposited $506,061 (the policy proceeds plus interest) in the court's registry.[282] The trial court granted summary judgment in Ed's current wife's favor and ordered State Farm to pay all of the proceeds to her save and except the unpaid alimony to Linda.[283] But Ed's current wife also claimed that State Farm violated the Texas prompt payment of claims statute by failing to pay her within sixty days; thus, entitling her to penalty interest of 18 percent and attorney's fees.[284]

One of the issues before the Texas Supreme Court was whether State Farm owed statutory penalties after the interpleader was filed.[285] The Texas Insurance Code provides no exception from statutory penalties when an interpleader is filed.[286] Nevertheless, in *Martinez* the Texas Supreme Court held that State Farm could not be assessed statutory penalties after the date the interpleader was filed. *Martinez* held:

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[273] State Farm Life Ins. Co. v. Martinez, 216 S.W.3d 799 (Tex. 2007).

[274] *Id.* at 800.

[275] *Id.*

[276] *Id.* at 801.

[277] *Id.*

[278] *Id.*

[279] *Martinez*, 216 S.W.3d at 801.

[280] *Id.*

[281] *Id.*

[282] *Id.*

[283] *Id.*

[284] *Id.*

[285] *Martinez*, 216 S.W.3d at 801.

[286] *Id.* at 805-806.

> Assessing penalty interest and attorney's fees after an interpleader is filed would punish insures for doing exactly what Texas law encourages. Indeed, the more difficult and protracted the dispute between rival claimants (and thus the more justified the interpleader), the larger those penalties would grow. We must avoid construing the prompt payment statute to reach such an absurd result.[287]

Thus, under *Martinez* an insurance company cannot be held liable for statutory penalties after an interpleader is filed and after the funds have been placed in the court's registry.

[287] *Id.* at 806.

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