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SUPPLEMENT NO. 6 TO THE REPORT OF THE LEGAL OPINIONS COMMITTEE REGARDING LEGAL OPINIONS IN BUSINESS TRANSACTIONS: STATEMENT ON CHANGES TO THE PROCEDURE FOR GOOD STANDING CERTIFICATES ISSUED BY THE TEXAS COMPTROLLER OF PUBLIC ACCOUNTS

Legal Opinions Committee of the Business Law Section

of the State Bar of Texas

This Statement (this "Supplement No. 6") by the Legal Opinions Committee of the Business Law Section of the State Bar of Texas (the "Committee")[1] addresses the recent

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[1] This Statement has been prepared by a Subcommittee of the Legal Opinions Committee of the Business Law Section of the State Bar of Texas consisting of the following members: Stephen C. Tarry (Chair), Bruce A. Cheatham, Byron F. Egan, Frank T. Garcia, Roderick A. Goyne, David R. Keyes, Gail Merel, Scott G. Night, Stan Pieringer, Daryl B. Robertson, Richard A. Tulli, and Geoffrey K. Walker. This Statement was approved by the Committee on July 25, 2013.

The Committee has published a report and a statement regarding third-party legal opinions under Texas law. See Legal Opinions Committee of the Business Law Section of the State of Texas, Report of the Legal Opinions Committee Regarding Legal Opinions in Business Transactions, Bulletin of the Business Law Section of the State Bar of Texas, (Special Issue) June—September 1992, at 1 (the "Texas Legal Opinions Report"). The Texas Legal Opinions Report has been supplemented on five occasions (collectively, the "Supplements"): Legal Opinions Committee of the Business Law Section of the State Bar of Texas, Supplement No. 1 to the Report of the Legal Opinions Committee Regarding Legal Opinions in Business Transactions, Bulletin of the Business Law Section of the State Bar of Texas, December 1994, at 1 (addressing certain Texas usury law issues); Legal Opinions Committee of the Business Law Section of the State Bar of Texas, Supplement No. 2 to the Report of the Legal Opinions Committee Regarding Legal Opinions in Business Transactions, Bulletin of the Business Law Section of the State Bar of Texas, Spring 2001, at 1(addressing Texas opinions regarding security interests in investment property collateral); Legal Opinions Committee of the Business Law Section of the State Bar of Texas, Supplement No. 3 to the Report of the Legal Opinions Committee Regarding Legal Opinions in Business Transactions: Statement on Legal Opinions Regarding Indemnification and Exculpation Provisions under Texas Law, 41 TEX. J. BUS. L. 271 (Winter 2006) (addressing Texas legal opinions regarding indemnification and exculpation provisions); Legal Opinions Committee of the Business Law Section of the State Bar of Texas, Supplement No. 4 to the Report of the Legal Opinions Committee Regarding Legal Opinions in Business Transactions: Statement on ABA Principles and Guidelines, 43 TEX. J. BUS. L. 1 (Spring 2009) (addressing the Legal Opinion Principles and the Guidelines for the Preparation of Closing Opinions published by the Committee on Legal Opinions of the Business Law Section of the American Bar Association); and Legal Opinions Committee of the Business Law Section of the State Bar of Texas, Supplement No. 5 to the Report of the Legal Opinions Committee Regarding Legal Opinions in Business Transactions: Statement on Entity Status, Power and Authority Opinions Regarding Pre-Code Texas Entities and Pre-Code Registered Foreign

announcements of the Texas Comptroller of Public Accounts (the "Comptroller") that the Comptroller has revised the definition of "good standing" for franchise tax purposes and that Certificates of Account Status (sometimes referred to as Certificates of Good Standing) will no longer be available from the Comptroller's Office. Instead of issuing Certificates of Account Status, the Comptroller will now provide information regarding an entity's franchise tax status through an online search mechanism, which will no longer set out a specified future date through which the information so provided will remain valid.

In summary, the Committee has concluded that, without further inquiry and without obtaining any additional certificate or other writing (other than a Certificate of Fact from the Texas Secretary of State showing that the entity is in existence) and without taking any related qualification or exception in a legal opinion, an opinion giver may rely on the Comptroller's online search mechanism to determine the status of an entity's Texas franchise tax account and to render a good standing opinion if the search mechanism expressly states that the entity's right to transact business in Texas is "active".

A. RENDERING A GOOD STANDING OPINION UNDER THE COMPTROLLER'S NEW PROCEDURE

Prior to the recent changes, under the Comptroller's prior procedure, "being 'in good standing' . . . meant that all franchise tax filing requirements had been met and no franchise tax was due".[2] Under the Comptroller's new procedure, "being 'in good standing' for franchise tax [purposes] will mean that [a taxable entity's] right to transact business in Texas is intact".[3] Pursuant to the Texas Tax Code, for franchise tax purposes, a taxable entity's right to transact business in Texas is intact if that right has not been forfeited as a result of the entity's failure to file a franchise tax report or to pay a franchise tax. The Texas Tax Code also provides that the Comptroller is required to forfeit a taxable entity's right to transact business in Texas if the entity does not file its franchise tax reports or pay it franchise taxes within forty-five days after

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Entities under the Texas Business Organizations Code, 45 TEX. J. BUS. L. 1 (Fall 2012) (addressing whether the application of the Texas Business Organizations Code has affected certain legal opinions commonly given in commercial transactions as such opinions relate to entities formed or registered to transact business in Texas prior to January 1, 2010). The Committee also published a statement regarding the Texas Supreme Court's decision in 1999 concerning the liability of Texas lawyers for negligent misrepresentation, Limiting Negligent-Misrepresentation Liability for Third-Party Legal Opinions, 38 TEX. J. BUS. L. 20 (Winter 2003). The Texas Legal Opinion Report and the Supplements are available electronically at the website of the Business Law Section of the State Bar of Texas at http://www.texasbusinesslaw.org/committees/legal-opinions.

[2] *Franchise Tax Account Status*, TAX POLICY NEWS (April 2013). *Tax Policy News* is the Comptroller's newsletter. For a more detailed description of the changes to the Comptroller's good standing procedure, *see* Part B, *infra*.

[3] "*Good Standing" Account Status – Changes are Coming*, TAX POLICY NEWS (January 2013). The Comptroller's updated definition of "good standing" is consistent with the typical meaning of the term "good standing" as described in the TriBar Closing Opinions Report (as hereinafter defined) and the Texas Legal Opinions Report. TriBar Opinion Committee, *Third-Party "Closing" Opinions*, 53 BUS. LAW. 592, 646 (Feb. 1998) (hereinafter, the "TriBar Closing Opinions Report") ("[g]ood standing opinions have been said to provide the opinion recipient comfort that a corporation's charter is not subject to revocation for failure to keep its state filings current"); Texas Legal Opinions Report, *supra* note 1, at 83 ("[a]n opinion with respect to the 'good standing' of a corporation means that the entity is in existence and is not delinquent in its filings of franchise tax returns to the extent that the State is entitled to revoke its corporate status").

the date on which the Comptroller mails a notice of delinquency to the entity.[4]

Prior to the recent changes in procedure, the Comptroller issued Certificates of Account Status in response to inquiries about the status of the franchise tax account of a taxable entity. Each Certificate of Account Status contained a statement that the Certificate was valid through a specified future date on which the entity's next franchise tax report would be due.

Under the new changes in procedure, the Comptroller has indicated that, as of May 5, 2013, the Comptroller's Office will respond to inquiries regarding franchise tax account status for taxable entities by providing the status of the taxable entity's right to transact business in Texas through an online search mechanism that is available on the Comptroller's website.[5] In response to such an online search as to a specific entity, the Comptroller's website produces a printable page bearing the heading "Franchise Tax Account Status", which is dated as of a particular date and time. If a taxable entity's right to transact business in Texas has not been forfeited as a result of the entity's failure to file a franchise tax report or to pay a franchise tax, the page shows that the taxable entity's right to transact business in Texas is "active". The printable page that results from such an online search is herein referred to as a "Statement of Franchise Tax Account Status". Unlike the prior Certificate of Account Status, the new Statement of Franchise Tax Account Status does not specify that the Statement is valid through a future date. In addition, the new Statements of Franchise Account Status are not acceptable

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[4] Under Sections 171.251 and 171.2515 of the Texas Tax Code, the Comptroller is required to forfeit the rights of a taxable entity to transact business (or, in the case of a corporation, to forfeit the corporation's corporate privileges) in Texas if the entity (a) does not file, in accordance with Chapter 171 of the Texas Tax Code and within 45 days after the date on which the Comptroller mails a notice of forfeiture to the taxable entity, a report required by Chapter 171, or (b) does not pay, within 45 days after the date on which the Comptroller mails a notice of forfeiture to the taxable entity, a tax imposed by Chapter 171 or a penalty imposed by Chapter 171 relating to such tax. Under the provisions of Section 171.252, if the privileges of a corporation are forfeited (x) the corporation shall be denied the right to sue or defend in a Texas court, and (y) each director and officer of the corporation becomes liable for certain debts of the corporation. As to entities other than corporations, Section 171.2515(b) of the Texas Tax Code provides that the provisions that apply to the forfeiture of corporate privileges also apply to the forfeiture of a taxable entity's right to transact business in Texas.

Section 171.256 of the Texas Tax Code provides that if the Comptroller proposes to forfeit the rights of a taxable entity to transact business in Texas, the Comptroller must notify the entity that the forfeiture will occur without a judicial proceeding unless, within the time periods established by Section 171.251, the entity files the overdue franchise tax reports or returns and/or pays the delinquent taxes, penalties or interest. Under the provisions of Section 171.258 of the Texas Tax Code, the Comptroller must revive the rights of a taxable entity to transact business in Texas if the taxable entity, before the forfeiture of its charter or certificate of authority, pays any tax, penalty, or interest due under Chapter 171.

Subchapter G of Chapter 171 of the Texas Tax Code contains the procedures by which the Comptroller may cause the forfeiture of a taxable entity's charter or certificate of authority if the taxable entity does not pay, within 120 days after its right to transact business in Texas is forfeited under Sections 171.251 and 171.2515, the amount necessary to revive its right to transact business as provided in Section 171.258 of the Texas Tax Code.

[5] For information regarding the Comptroller's changes in procedure, see the following statement on the Comptroller's website: http://www.window.state.tx.us/taxinfo/coasintr.html (hereafter referred to as the "Comptroller's Information on Good Standing"). The online franchise tax account status search mechanism that is now available on the Comptroller's website can be found at the following web address: https://ourcpa.cpa.state.tx.us/coa/Index.html.

for filings with the Texas Secretary of State.[6]

It is common for legal opinions rendered in connection with the closing of business transactions to include a statement that an entity is "in good standing" under the laws of its state of organization. As to the meaning of the term "good standing", the TriBar Closing Opinions Report concludes that while the meaning varies from state to state, there is a commonly accepted definition:

When used in an opinion, the term "good standing" is understood as a matter of customary usage to cover the matters addressed by the certificates of government officials that lawyers in the jurisdiction in question customarily obtain to support the opinion.[7]

The TriBar Closing Opinions Report also provides that "[g]ood standing opinions customarily are based solely on certificates of government officials . . . ."[8] The Committee agrees with and adopts the forgoing conclusions of the TriBar Closing Opinions Report. The Committee also agrees with the conclusion of the TriBar Closing Opinions Report that "because opinion preparers customarily do nothing more than rely on certificates of government officials (which are normally presented at closing), good standing opinions usually add little of value analytically" and that "[i]n situations in which the benefits of good standing opinions are marginal, . . . the opinion process could be streamlined if opinion recipients were to refrain from requesting them and relied on the certificates alone."[9]

In the information provided by the Comptroller regarding the changes in the good standing procedure, the Comptroller indicates that the online search procedure and the resulting Statement of Franchise Tax Account Status are intended to be responsive "to inquiries about the status of an entity's franchise tax account" and "accomplish the same purposes" as the prior Certificate of Account Status, although the Statement is neither expressly presented nor formulated as a certificate.[10] In light of the Comptroller's explanation of the changes in procedure, the Committee believes that, as to a taxable entity that is subject to Texas franchise taxes:

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[6] To obtain a Comptroller's certificate of account status for filing with the Texas Secretary of State, which is required when an entity intends to terminate its legal existence, Comptroller's Form 05-359 (*Request for Certificate of Account Status to Terminate a Taxable Entity's Existence in Texas or Registration*) must be completed and transmitted to the Comptroller's Office.

[7] TriBar Closing Opinions Report, *supra* note 3, at 645. *See also* Donald W. Glazer, Scott FitzGibbon and Steve O. Weise, GLAZER AND FITZGIBBON ON LEGAL OPINIONS 231 (3d ed. 2008) (a good standing opinion "normally is based entirely on a certificate presented at closing, and as a matter of customary practice, the opinion is understood to mean whatever the certificate means").

[8] *Id*. The Texas Legal Opinions Report reaches the same conclusion:

> The "good standing" opinion is usually rendered based solely on recently dated certificates of public officials. It is not necessary to state in the opinion that the attorney has relied solely on those certificates in rendering the "good standing" opinion since that is the customary practice and the recipient of the opinion is entitled to no further investigation on this point.

Texas Legal Opinions Report, *supra* note 1, at 84.

[9] *Id*. at 645-646.

[10] Comptroller's Information on Good Standing, *supra* note 5.

(1) an opinion giver may use the Comptroller's online search mechanism to determine the status of the entity's franchise tax account as of the date, or shortly before the date, on which the good standing opinion is rendered; and

(2) if the resulting Statement of Franchise Tax Account Status expressly states that the entity is "active", the opinion giver may, without further inquiry and without obtaining any additional certificate or other writing (other than a Certificate of Fact from the Office of the Texas Secretary of State showing that the "entity status in Texas is in existence")[11] and without taking any related qualification or exception in a legal opinion, rely upon such Statement in rendering an opinion that the entity is in good standing under the laws of State of Texas as of the date of such Statement.

To the extent that the Texas Legal Opinions Report is inconsistent in any respect with the foregoing, the Texas Legal Opinions Report is hereby amended by the provisions of this Supplement No. 6.

If, notwithstanding the foregoing, an opinion giver wants to include an express qualification in a legal opinion regarding reliance on a Statement of Franchise Tax Account Status, an opinion giver might consider language similar to the first sentence set forth below. If, for any reason, an opinion giver also wants to further explain the recent changes in the Comptroller's good standing procedure, the opinion giver might consider the language in the second sentence.

In rendering our opinion in paragraph [insert paragraph number] above as to the good standing of [insert name of entity] in Texas, we have relied solely upon a statement of Franchise Tax Account Status dated as of [insert date of Statement of Franchise Tax Account Status] obtained through the website of the Office of the Comptroller of Public Accounts of Texas, which statement expressly states that, as of the date thereof, the right of [insert name of entity] to transact business in Texas is "active". We note that effective as of May 5, 2013, the Comptroller's Office changed its procedure so that the terms "good standing" and "active" now mean that a relevant taxable entity's right to transact business in Texas has not been forfeited by the Comptroller's Office because of the entity's failure to file franchise tax reports or pay franchise taxes; prior to this change in procedure, the term "good standing" meant that all franchise tax filing requirements had been met and no franchise tax was due.

However, for the reasons outlined above, the Committee believes that the inclusion of either or both of these sentences in a Texas good standing opinion is unnecessary since such an opinion is customarily rendered solely on the basis of information provided by government officials without the need for any further qualification or explanation.

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[11] If the Office of the Texas Secretary of State will not issue a Certificate of Fact indicating that an entity is in existence, then prior to rendering a good standing opinion as to that entity, an opinion giver will need to address appropriately the matters that resulted in the entity's existence no longer being recognized by the Secretary of State. In the Committee's experience, it is rare for an opinion to cover the good standing of an entity without also covering the existence of the entity.

B. DESCRIPTION OF CHANGES TO COMPTROLLER'S GOOD STANDING PROCEDURE

Opinion givers and opinion recipients may want to know more about the specifics of the changes in the good standing procedure that the Comptroller has implemented. Knowledge of the effects of these changes may, among other things, be of concern in drafting representations and warranties in transaction documents regarding the filing of Texas franchise reports and the payment of Texas franchise taxes.[12] Set forth below is a description of the Comptroller's procedure both before and after giving effect to the recent changes.

As is noted above, the Comptroller's change in its good standing procedure reflects a modification of the Comptroller's views regarding the definition of the term "good standing". Under the procedure in effect prior to May 5, 2013, the Comptroller concluded that an entity was "in good standing" and could therefore obtain a Certificate of Account Status when all of the entity's franchise tax filing requirements had been met and no franchise tax was due from the entity.[13] Under the Comptroller's old procedure, during the peak franchise report filing periods, the Comptroller changed the status of all franchise tax accounts to "Temporary Good Standing" in order to allow the Comptroller's office sufficient time to process all of the franchise tax reports. While an entity was in "Temporary Good Standing", the Comptroller would not generally issue a Certificate of Account Status stating that the entity was in good standing.[14] Once the franchise tax report for an entity was processed, the entity's status would then change to either "good standing" or "not in good standing". The "not in good standing" status meant, among other things, that the entity's required franchise tax reports had not been properly filed or the appropriate amount due (tax, penalty or interest) had not been paid. Once an entity was placed into the "good standing" category, that entity would have remained in good standing through the date on which the entity's next franchise tax report or payment was due. Thus, under the old procedure, the Comptroller would not generally issue a Certificate of Account Status for an entity if that entity had failed to file its franchise tax reports when such

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[12] It is not unusual for credit agreements and other transaction documents to contain general representations regarding the filing of tax returns and the payment of taxes. If the parties desire to include more specific language regarding Texas franchise taxes, the following representations could be considered to take account of the Comptroller's changes in procedure:

> a) the company has not received a notice from the Texas Comptroller of Public Accounts or any other governmental official stating that the company's right to transact business in Texas has been terminated or that the Texas Comptroller of Public Accounts or such other official intends or proposes to terminate the company's right to transact business in Texas;
>
> b) no law suit or other legal proceeding has been filed in the State of Texas seeking to terminate or revoke the company's charter or certificate of authority; and
>
> c) the company has duly and timely filed all franchise tax reports and returns required under Texas law and has duly and timely paid all franchise taxes that are due and owing under Texas law, in each case on or before the due date thereof.

[13] *Franchise Tax Account Status*, TAX POLICY NEWS (April 2013).

[14] In the case of an entity that had filed its franchise tax reports and paid all amounts owed thereunder, but was still shown to be in "Temporary Good Standing" because the Comptroller had not processed the entity's franchise tax reports, the Comptroller did offer assistance to the entity when a Certificate of Status was necessary in order to close a transaction or receive a license or permit.

reports were due or had failed to pay any amounts owed in connection with such reports.[15]

In the Comptroller's newsletter published in January of 2013, the Comptroller announced that "changes are coming" to the Comptroller's "good standing" account status procedure:

Businesses have been reporting under the revised franchise tax since 2008. Due largely to the complications of combined reporting, companies can be "not in good standing" due to a reporting error, not a tax delinquency. A "not in good standing" status can be costly to a company conducting a business or financial transaction.

The Comptroller took another look at good standing in light of concerns from businesses. The result of that review is that being "in good standing" for franchise tax will mean that the company's right to transact business in Texas is intact.

The Comptroller further noted that "[b]eing in good standing has evolved over the years, as we made changes to accommodate processing times and filing requirement changes" and that "this new definition means that a business will receive a written notice of any issues with its franchise tax filing and will have at least 45 days to cure those issues, before the business is not in good standing".[16]

In summary, under the old procedure, the Comptroller's issuance of a Certificate of Account Status certifying that an entity was "in good standing" meant that the entity's franchise tax reports had been filed and that all franchise taxes owed by the entity had been duly paid. Under the new procedure, a Statement of Franchise Tax Account Status procured from the Comptroller's website will show that an entity's right to transact business in Texas is "active" even if the entity has failed to file its franchise tax reports or failed to pay the franchise taxes it owes, so long as the Comptroller has not forfeited the entity's right to transact business in Texas. Under the relevant provisions of the Texas Tax Code, the Comptroller may forfeit the entity's right to transact business no earlier than 45 days after the Comptroller sends a notice of the proposed forfeiture to the entity stating that the entity continues to be delinquent in filing its franchise tax reports or in paying its franchise taxes.

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[15] The description of the Comptroller's old procedure for good standing matters as set forth in this paragraph is based upon various documents that have been posted on the Comptroller's website.

[16] *"Good Standing" Account Status – Changes are Coming*, TAX POLICY NEWS (January 2013). As is discussed in greater detail in footnote 4 above, in the case of an entity that fails to timely file a franchise tax report or to pay franchise taxes when due, the Comptroller may forfeit that entity's right to transact business in Texas only if 45 days have passed since the Comptroller gave the entity notice of the proposed forfeiture.

DUDE, WHERE'S MY CAR? HOW THE PROPOSED UNIFORM CERTIFICATE OF TITLE ACT ADDRESSES CONFLICTS BETWEEN THE TEXAS CERTIFICATE OF TITLE ACT AND THE UNIFORM COMMERCIAL CODE

Jonathon C. Clark*

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* The author would like to thank Professor John E. Krahmer, Professor of Law and Foundation Professor of Commercial Law at Texas Tech School of Law, for his assistance with and contributions to this article.

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This article was originally published by the Consumer Finance Law Quarterly Report but has been updated for this publication. *See* Jonathon C. Clark, 63 CONSUMER FIN. L.Q. REP. 124 (Spring-Summer 2009).

I. DUDE, WHERE'S MY CAR?: THE COMMON PROBLEM

Commonly, when purchasing a vehicle, a consumer, whom we will call Joe, goes to a dealership and looks around for an affordable and suitable vehicle. After haggling with the salesperson over the terms, making a deal, and arranging a form of payment, Joe fills out paperwork to transfer the ownership of the vehicle and pays the dealer to cover the titling expenses, which the dealer promises to send to the state certificate of title ("CT") office so that the ownership of record may be transferred to Joe pursuant to the state's CT law.[1]

Joe leaves the dealership with the new car, perhaps a little nervous about all the money spent and the additional debt incurred. After Joe is gone, the dealership, which may be experiencing legal and/or financial problems and perhaps is even insolvent, may use the money Joe paid, including that intended to cover the ownership transfer costs, to pay other creditors. Later, stretched to the limit, the dealer may run short of funds and default on the dealer's inventory or other loan with a bank, before transferring the CT for Joe's car. Then, maybe two weeks after purchasing the car, Joe attempts to leave home for work, but instead finds his vehicle in the process of being repossessed by the bank.[2]

Joe, extremely confused and irritated, may find that, while Joe filled out the appropriate documentation needed for a CT application, the dealer did not file the documentation with the state CT office, which means that the bank with the dealership inventory loan still claims a security interest in the vehicle.[3] When the dealership defaulted, the bank searched for and repossessed the collateral for its loan, including Joe's new car.[4] Now, Joe must file a declaratory action and argue that a judge should declare Joe to be the proper owner under generally applicable laws including the Uniform Commercial Code ("UCC"), property and contract laws, and perhaps equitable principles, the applicable CT law, and even the Bankruptcy Code. Each of these laws is challenging in this context, and the relations between them add to the complexity. Joe may be facing a very expensive (and uneconomical) lawsuit as his only legal remedy.

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[1] It should be noted that in most such transactions ownership passes to the buyer under the sales contract at the time of the sale, pursuant to state property and contract law (including Uniform Commercial Code (U.C.C.) Article 2), independently of the state CT law. The additional ownership documentation executed by the dealer (for example, a CT or certificate of origin) at the time of sale or (more commonly) later facilitates the buyer's application for a new CT but is not essential to the transfer of ownership. *See, e.g.*, U.C.C. §§ 2-401 to 2-403. However, it may be necessary as part of the buyer's application for the license tags needed in order to drive the vehicle on public roads.

[2] An even more common version of this scenario arises when Joe cannot obtain a license tag, and therefore cannot drive the car, because the dealer has failed to transfer the CT documentation as promised. *See id*.

[3] Although Joe is the legal owner of the vehicle, the records of the state CT office, the secured lender, and perhaps even the dealer still reflect ownership by the dealer, indicating to these parties that the vehicle remains collateral for the bank's loan. Inventory or "floor-plan" financing means "[a] loan that is secured by merchandise and paid off as the goods are sold . . . Also termed *floor planning*." BLACK'S LAW DICTIONARY 663 (9th ed. 2009). In effect, this is a loan secured by the dealer's inventory.

[4] In some cases the secured party who is unable to locate the vehicle may report the vehicle stolen, creating a significant potential for Joe's arrest, which could result in additional hassle, embarrassment, and problems for Joe. *See, e.g.*, Gallas v. Car Biz, Inc., 914 S.W.2d 592, 594–95 (Tex. App.—Dallas 1995, writ denied).

This type of situation poses a very real set of problems for the average Joe; and buying a car is a significant investment for many people. Given that approximately "70 million motor vehicles are titled in the United States" each year, the opportunity for these issues to arise occurs frequently.[5] Problems like Joe's potentially arise each time a dealer sells a vehicle but does not transfer a CT or certificate of origin to the buyer at the time of purchase.[6] If the buyer leaves the dealership with an executed CT, the bank's security interest in the vehicle clearly is cut off; however, common practice among car dealers is to buy or sell a vehicle and transfer the CT at a later date.[7]

Joe's problems arise in part because confusing state CT laws have led even appellate courts to apply conflicting rules to this situation.[8] For example, in Texas the courts have applied the UCC and the Texas Certificate of Title Act (Texas CT law) in conflicting ways, creating a split among the Texas appellate courts.[9] This conflict poses significant problems for consumers and other vehicle purchasers: Under the UCC, the purchaser is entitled to possession and ownership of the vehicle even without a transfer of the CT;[10] however, some CT laws can be interpreted to provide that a sale is void without a CT transfer. Some courts

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[5] See the Uniform Certificate of Title Act ("UCOTA"). Prefatory Note at 1 (2006). Texas law requires: "The owner of a motor vehicle that is required to be registered in this state must apply for a certificate of title of the vehicle before selling or disposing of the vehicle." TEX. TRANSP. CODE ANN. § 501.022(c) (West 2007). Among other things, in our sample scenario Joe will be in violation of this and similar statutory requirements, some of which carry heavy penalties.

[6] *See infra* Part III.

[7] *See* U.C.C. § 9-320 (buyer in ordinary course of business takes free of security interest created by the seller). However, even this simple point can become muddled in the context of confusing CT laws. If the vehicle is new (i.e., has never been covered by a CT) a certificate of origin is required rather than a CT. *See, e.g.*, Alvin C. Harrell, *The Uniform Certificate of Title Act: Myths and Realities*, 39 UCC L.J. 1 (2006); *see also* TEX. TRANSP. CODE ANN. § 501.0234(f). Section 501.0234(f) states, "A seller has a reasonable time to comply with the terms of Subsection (a)(1) and is not in violation of that provision during the time the seller is making a good faith effort to comply. Notwithstanding compliance with this chapter, equitable title to a vehicle passes to the purchaser of the vehicle at the time the vehicle is the subject of a sale that is enforceable by either party." TEX. TRANSP. CODE ANN. § 501.0234(f). Section 501.0234(a)(1), referred to above, requires that: [a] person who sells at the first or subsequent sale a motor vehicle and holds a general distinguishing number, [essentially meaning the individual is a registered dealer or wholesaler of vehicles,] . . . shall: . . . in the time and manner provided by law, apply, in the name of the purchaser of the vehicle, for the registration of the vehicle, if the vehicle is to be registered, and a certificate of title for the vehicle and file with the appropriate designated agent each document necessary to transfer title to or register the vehicle . . . . TEX. TRANSP. CODE ANN. § 501.0234(a)(1) (West 2007).

[8] *Compare, e.g.*, Park Cities Ltd. P'ship. v. Transpo Funding Corp., 131 S.W.3d 654 (Tex. App.—Dallas 2004, no pet.) (holding that the CT law applies); *and Gallas*, 914 S.W.2d at 594–95 (holding that the CT law applies), *and* Morey v. Page, 802 S.W.2d 779 (Tex. App.—Dallas 1990, no writ) (holding that the CT law applies), *and* Pfluger *v.* Colquitt, 620 S.W.2d 739 (Tex. Civ. App.—Dallas 1981, writ ref'd n.r.e.) (holding that the CT law applies), *with* Vibbert v. PAR, Inc., 224 S.W.3d 317, 324 (Tex. App.—El Paso 2006, no pet, h.) (holding that the UCC applies), *and* First Nat'l Bank v. Buss, 143 S.W.3d 915 (Tex. App.—Corpus Christi 2004, pet. denied) (holding that the UCC applies), *and* Hudson Buick v. Gooch, 7 S.W.3d 191 (Tex. App.—Tyler 1999, pet. denied) (holding that the UCC applies). In reality, of course, both the UCC and the CT law apply; but as noted *infra* the interface between them is so poorly defined in the CT laws that unnecessary conflicts are either created or perceived.

[9] Texas adopted the UCC into the Texas Business and Commerce Code in 1965; therefore, the term "Code" as used in case decisions may refer to either the Uniform Commercial Code or its codified version in Texas, the Texas Business and Commerce Code. *See* TEX. BUS. & COM. CODE ANN. §§ 1.01–11.108 (West 2002).

[10] *See supra* note 1.

have held that in these circumstances the dealership never transferred the right of possession and ownership to the purchaser; therefore, those rights accrued to the lender when the dealer defaulted.[11] As noted, a legal battle to determine ownership of the vehicle can be expensive and burdensome, with costs easily exceeding the value of the vehicle; this can be devastating for someone who purchased the vehicle as needed transportation. The transaction often leaves the buyer in no position to join in a legal battle over the money paid to the dealer at the time of purchase, and possibly the vehicle itself.[12]

The split among the Texas appellate courts on these issues mirrors national developments; it arises because the party claiming a valid transfer of ownership and severance of the security interest (the buyer) generally relies on the UCC, while the secured party claiming the right to the vehicle via a security interest cites the CT law.[13] The party citing the UCC argues that, although the CT was not transferred to him or her, he or she is protected as a buyer in ordinary course of business ("BIOCOB") as against a security interest created by the seller; however, the party citing the CT law claims that without a transferred CT no sale occurred and therefore there is no BIOCOB, and the security interest remains intact.[14] In Texas, appellate courts have split over whether the CT law or the UCC controls.[15]

The confusion in Texas has occurred even though the Texas CT law has a reverse preemption clause, which seems to resolve the issue, by stating: "Chapters 1-9, Business and Commerce UCC, control over a conflicting provision of this chapter."[16] Under this language one might logically conclude that the UCC controls, but some courts have concluded that no conflict exists because the court interprets statutes so that any apparent conflict may be harmonized.[17] Again, one might logically conclude that this means an interstitial CT law (designed largely as an anti-fraud device)[18] would be viewed in conformity with the comprehensive law governing sales of goods and security interests (the UCC). The UCC

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[11] *See Park Cities Ltd. P'ship.*, 131 S.W.3d at 654 (the CT law applies); *Gallas*, 914 S.W.2d at 594-95 (the CT law applies); *Morey*, 802 S.W.2d at 779 (the CT law applies); *Pfluger*, 620 S.W.2d at 739; *cf. Vibbert*, 224 S.W.3d at 324 (the UCC applies); *Buss*, 143 S.W.3d at 915 (the UCC applies); *Gooch*, 7 S.W.3d at 191 (the UCC applies).

[12] *See* cases cited *supra* notes 8 and 11. Two consequences usually follow a loss for the buyer in this type of litigation: Either the buyer will lose all money paid at the time of purchase, typically a down payment plus the cost of tags, title documentation, and license, or will lose that money plus the vehicle. If the buyer loses only the money paid at the time of purchase that usually means the buyer came to an agreement with the secured party to make payments directly to the secured party so that the buyer could keep the vehicle. Of course, it is also possible that the buyer could lose the vehicle and money paid, *and* be liable for repayment of loan proceeds paid by the buyer's lender to the dealer.

[13] *See* cases cited *supra* at notes 8 and 11.

[14] *Id*. The UCC and the Texas Business and Commerce Code define a buyer in the ordinary course of business as: . . . a person that buys goods in good faith and without knowledge that the sale violates the rights of another person in the goods, and in the ordinary course from a person, other than a pawnbroker, in the business of selling goods of that kind. A buyer buys good in the ordinary course if the sale to the person comports with the usual or customary practices in the kind of business in which the seller is engaged or with the seller's own usual or customary practice. U.C.C. § 1-201(b)(9); TEX. BUS. & COM. CODE ANN. § 1.201(b)(9) (West Supp. 2007).

[15] *See* cases cited *supra* at notes 8 and 11.

[16] *See* TEX. TRANSP. CODE ANN. § 501.005 (West 2007). Given the problems in Texas, as noted here, even with this seemingly clear provision, one can only imagine the problems lurking in other states that lack such language.

[17] *See, e.g.*, *Pfluger*, 620 S.W.2d at 741–42 (citing other cases).

[18] *See infra* Part II.B.

clearly protects a BIOCOB from a seller's security interest. However, if the court applies the CT law to the exclusion of contrary provisions in the UCC, on grounds that there is no conflict, the lender's security interest may be held superior to the innocent buyer's right of ownership, costing the buyer the money paid for the vehicle and, possibly, the vehicle itself.[19] Ultimately, the *Pfluger* court noted that the plain meaning of the UCC contradicts this interpretation of the CT law, so the *Gallas* court's conclusion that no conflict exists is incorrect, as each law leads to diametrically opposed results.[20]

To address such conflicts between the UCC and state CT laws, in both intrastate and interstate contexts, the National Conference of Commissioners on Uniform State Laws ("NCCUSL") (now also known as the Uniform Law Commissioners, or "ULC") approved and recommends adoption of the Uniform Certificate of Title Act ("UCOTA") by the states.[21] UCOTA provides needed protections for buyers and lessees in the ordinary course of business in these circumstances, and reconciles existing conflicts with the UCC.[22] Contained within UCOTA are provisions which recognize and follow UCC section 9-320, thereby protecting the BIOCOB in a vehicle purchase and making clear that a sale to a BIOCOB terminates a security interest in the vehicle created by the seller.[23] UCOTA also recognizes the entrustment rule in UCC section 2-403(2), which provides that any ownership interest of a secured party who entrusts the vehicle to a merchant seller is cut off by a sale of the vehicle to a BIOCOB.[24] Even when the CT is not executed to the buyer, which is the common scenario in retail sales, UCOTA clarifies that an otherwise qualified buyer qualifies as a BIOCOB.[25]

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[19] *See supra* note 12; cases cited *supra* at notes 8 and 11; and *infra* Part III.

[20] *See Pfluger*, 620 S.W.2d at 741–42; cases cited *supra* at notes 8 and 11.

[21] *See, e.g.*, Edwin E. Smith, *The Effect of the Uniform Certificate of Title Act on Secured Transactions*, CONSUMER FINANCE LAW QUARTERLY REPORT, Vol. 60, 366, 366 (Summer 2006).

[22] *Id*. at 388.

[23] *Id*. Section 9.320 of the Texas Business and Commerce Code, Texas's version of section 9-320 of the UCC, states:

> a). . . [A] buyer in ordinary course of business . . . takes free of a security interest created by the buyer's seller, even if the security interest is perfected and the buyer knows of its existence.
>
> b). . . [A] buyer of goods from a person who used or bought the goods for use primarily for personal, family, or household purposes takes free of a security interest, even if perfected, if the buyer buys:
>
> 1. without knowledge of the security interest;
>
> 2. for value;
>
> 3. primarily for the buyer's personal, family, or household purposes; and
>
> 4. before the filing of a financing statement covering the goods.

TEX. BUS. & COM. CODE ANN. § 9.320(a)-(b) (West 2002).

[24] *See, e.g.*, *Smith*, *supra* note 21, at 388. Section 2.403(b) of the Texas Business and Commerce Code, Texas's version of U.C.C.§ 2-403(2), states: "Any entrusting of possession of goods to a merchant who deals in goods of that kind gives him power to transfer all rights of the entruster to a buyer in ordinary course of business." TEX. BUS. & COM. CODE ANN. § 2.403(b) (West 1994).

[25] *See, e.g.*, *Smith*, *supra* note 21, at 388.

These important issues clearly support the proposed adoption of UCOTA. In analyzing these issues, this article discusses the current split created at the state appellate court level in Texas and how the adoption of UCOTA can remedy that split. Part II. of this article analyzes the legislative intent and purposes behind adoption of the Texas UCC and the Texas CT law.[26] Part III. examines the particular laws applied in various appellate cases and the reasoning the courts have used to support application of those laws to the specific situation.[27] Part IV. describes UCOTA, and its purposes, and how those purposes apply to the conflicts in Texas.[28] Part V. advocates that the Texas Legislature adopt UCOTA, as the obvious and simple solution to these problems.[29] Ultimately, this article advocates Texas's adoption of the UCOTA as the best means to resolve conflicting applications of the CT law and UCC, to bring Texas law into conformity with common business and CT practices, and to protect the reasonable expectations and interests of innocent consumers.

II. A WAR OF ATTRITION: THE TEXAS CT LAW VERSUS THE UCC

A. Introduction

Texas enacted both the UCC and the CT law with purposes that are generally consistent and obvious; however, changing conditions, ambiguous provisions and poor draftsmanship in the CT law, and evolving issues have challenged those apparent purposes over time, leading to conflicts in applications of the statutes that were not foreseen or intended.[30] In comparing these cases with the legislative intent of the UCC and the CT law, one can readily see how the courts' applications of these laws often does not match the legislature's intentions and how adoption of the UCOTA can properly realign Texas law.[31]

B. The Texas CT Law

The legislature provided insight into the intent behind its adoption of the Texas CT law through the text of the law.[32] Section 501.003 of the Texas CT law provides directions on construction of the law.[33] It states that courts should liberally construe the Texas CT law in order "to lessen and prevent: (1) the theft of motor vehicles; (2) the importation into this state of and traffic in motor vehicles that are stolen; and (3) the sale of an encumbered motor vehicle without the enforced disclosure to the purchaser of a lien secured by the vehicle."[34] The legislature first enacted a CT law in 1939 to establish a CT system to accomplish these purposes for motor vehicles.[35] Thus, two basic purposes have been recognized for establishing

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[26] *See* discussion *infra* at Part II.

[27] *See* discussion *infra* at Part III.

[28] *See* discussion *infra* at Part IV.

[29] *See* discussion *infra* at Part V.

[30] *See* discussion *infra* at Parts III.A–B.

[31] *See* discussion *infra* at Parts III.A–B.

[32] *See infra* text accompanying notes 33–34.

[33] *See* TEX. TRANSP. CODE ANN. § 501.003 (West 2007).

[34] *Id*. (according to Reviser's Note (1): "the legislative intent and public policy intended by the statute" is shown by the operative provisions of the law).

[35] Millard H. Ruud, *Amendment of the Certificate of Title Act to Conform it to the Uniform Commercial Code*,

the Texas CT law: (1) to document the authority of the person named in the CT to deal with the ownership of the vehicle, which facilitates transfers of ownership and deters trafficking in stolen vehicles; and (2) to provide a means by which the security interest in motor vehicles may be perfected through compliance with the CT law.[36]

Following adoption of the UCC in Texas, the legislature also enacted the above noted section 501.005 of the CT law, giving the UCC primacy in conflicts between the two laws; therefore, that section's intent is separate from that of the rest of the Texas CT law.[37] The Texas Legislature thus amended the CT law to conform with the purposes of the UCC.[38] The principal purpose of this amendment was to remove the provisions of the Texas CT law repealed by implication when the legislature adopted the UCC.[39] The legislature obviously believed that the continued presence of these impliedly repealed statutes presented the potential for confusion and miscarriages of justice.[40] The legislature also made other changes to the Texas CT law, in addition to deletion of the provisions repealed by implication, in an effort to assure consistency between the Texas CT law and the UCC.[41] The legislature then inserted section 65, now section 501.005, to be a catch-all, to cover any remaining conflicts not specifically addressed in the amendment.[42] A purpose of inserting this section was to minimize the risk of harmful judicial errors, e.g., during a delay between the first litigation in a trial court, where someone might erroneously contend or conclude that the Texas CT law controls over the UCC, and an appellate court's action to correct the erroneous interpretation.[43] Moreover, in Texas, where the legislature meets only every two years, a considerable amount of time could pass before the legislature could amend the Texas CT law to correct specific conflicts brought to its attention via the court system. In the meantime, important transactions could be impaired.

This amendment, added in section 6 of the Texas CT law, created the provision that expressly recognizes the UCC's primacy in the event of a conflict with the Texas CT law, as currently found at Texas Transportation Code section 501.005.[44] The subsequent section of the

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33 TEX. B.J. 968, 968 (1970).

[36] *Id. See also* U.C.C. Article 9 §§ 9-102(a)(10), 9-109, 9-310, and 9-311(a) (establishing required criteria for the CT law in order to accomplish the latter purpose).

[37] Section 501.005 is also consistent with the role of the CT law in relation to the UCC. *See* U.C.C. Article 9 §§ 9-102(a)(10), 9-109, 9-310, and 9-311(a); *see also* TEX. TRANSP. CODE ANN. § 501.005 (West 2007) (stating: "Chapters 1-9, Business & Commerce Code [the provisions of the UCC], control over a conflicting provision of this chapter."). Thus, section 501.005 essentially recognizes that UCC Article 9 is the primary law governing security interests (see section 9-109), and that the CT law has only a supplementary rule (as limited at U.C.C. § 9-311(a)).

[38] *See* Act of May 10, 1971, 62d Leg., R.S., ch. 123, §§ 1-8, 1971 Tex. Gen Laws 895 (amended 1973 and 1995).

[39] Ruud, *supra* note 35, at 969.

[40] *Id*.

[41] *Id*.

[42] *Id*.; *see also supra* note 37; TEX. TRANSP. CODE ANN. § 501.005 (West 2007).

[43] Ruud, *supra* note 35, at 969. This purpose recognizes the major harm that can be done to consumers while the legal system adjusts an erroneous trial court interpretation on issues that are common yet inherently difficult and susceptible to confusion.

[44] *See* Act of May 10, 1971, 62d Leg., R.S., ch. 123, § 6, 1971 Tex. Gen Laws 895 (amended 1973 and 1995) (current version at TEX. TRANSP. CODE ANN. § 501.005 (West 2007)).

amendment, section 7, noted the importance of these changes in declaring the necessity to immediately and expressly repeal sections of the Texas CT law that conflicted with the UCC, already repealed by implication, in order to remove any doubt and provide consistency between the Texas CT law and the UCC.[45]

Shortly after the legislature amended the CT law to expressly clarify that the UCC repealed conflicting sections of the Texas CT law, the Houston Court of Appeals (Houston court) decided *Nelms v. Gulf Coast State Bank*,[46] a case requiring the court to determine the intent behind the legislature's actions. Before the legislature enacted the UCC, the Texas CT law provided rules governing the priority of a security interest in a vehicle covered by a Texas CT.[47] Under these provisions of the Texas CT law, a mechanic's lien would be subordinate to a security interest.[48] Because the sections of the Texas CT law that provided for priority of a security interest were not expressly repealed upon the Texas Legislature's adoption of the UCC, but were only repealed by implication, uncertainty regarding the priority of mechanic's liens on automobiles arose.[49]

As noted, in response to this uncertainty, the legislature amended the Texas CT law in conjunction with enactment of the UCC; this not only removed many of the conflicting provisions from the Texas CT law, but also included the noted savings clause (now section 501.005) to clear up future confusion involving the primacy of the UCC over the Texas CT law.[50] Ultimately, the *Nelms* court concluded that "the legislature must be presumed to have intended some amendment of existing law."[51] To find otherwise would contradict the legislative process.[52] The reasoning of the court in *Nelms* followed the comments of Professor Millard R. Ruud regarding the 1971 amendment of the Act.[53] Professor Ruud said of the four repealed provisions of the CT law, which dealt with the priority of various parties holding security interests in a motor vehicle against one another and against creditors and purchasers, that "[t]hese matters are now governed by the priority provisions of Chapter 9 [UCC Article 9]. . . ."[54]

The Texas Legislature intended to facilitate transfers of ownership (and perfection of

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[45] *See* Act of May 10, 1971, 62d Leg., R.S., ch. 123, § 7, 1971 Tex. Gen Laws 895 (calling the need for an expedited vote and immediate effectiveness an emergency).

[46] Nelms v. Gulf Coast State Bank, 516 S.W.2d 421 (Tex. Civ. App.—Houston [1st Dist.] 1974), *aff'd*, 525 S.W.2d 866 (Tex. 1975). Nelms involved a dispute over ownership of a vehicle between a mechanic, who held a mechanic's lien on the vehicle, and the security interest of the bank with whom the owner of the vehicle was in arrears. *Id*. at 422.

[47] *Id*.

[48] *Id*.

[49] *Id*. at 423; *see also* Ruud, *supra* note 35, at 968–69.

[50] *Nelms*, 516 S.W.2d at 423.

[51] *See id*. at 424.

[52] *Id*.

[53] Ruud, *supra* note 35, at 969.

[54] *Id*. Since that time, priority has been governed by UCC Article 9, and the scope of the Texas CT law has been limited to the process of perfection. *See* U.C.C. §§ 9-109, 9-311.

security interests) through the Texas CT law, not to hinder or prevent them.[55] The legislature passed the Texas CT law with the knowledge that it would not stop all sales and trafficking of stolen vehicles, but merely deter them.[56] However, the legislature felt the necessity to return again to the Texas CT law and amend it following the adoption of the UCC in an effort to provide consistency with the UCC.[57] Clearly the legislature did not intend to exclude protection of an innocent buyer in circumstances like Joe's, when it adopted and later amended the Texas CT law, and thus the legislature indicated a clear purpose of making the Texas CT law consistent with the UCC.[58] In adopting the UCC, the legislature intended to protect innocent buyers, a consistent theme throughout the UCC; the legislature reinforced this intention when it passed what is now section 501.005 of the Texas Transportation Code, deferring to the UCC in the event of a conflict with the CT law.[59]

C. The UCC

Before the UCC became effective in Texas in 1966, the Texas CT law was undoubtedly the law to which a court would turn in a situation such as Joe's.[60] The UCC included an intentional shift toward protecting the innocent purchaser, and the legislature amended the CT law to reflect this change.[61] Significant effort was undertaken by citizens all around the state to get the UCC passed in Texas.[62] The public effort to enact the UCC began as early as 1951, with a resolution to study the UCC's effect on Texas law.[63] Legislators introduced legislation to enact the UCC in 1951, 1953, 1963, and 1965 (a reminder of how difficult it is to enact landmark legislation, even when the need and benefits are so apparent), and the Governor signed the UCC bill into law on June 18, 1965, effective July 1, 1966.[64]

The Texas Legislature, emphasizing the importance of reforming the outdated laws governing commercial transactions in Texas and the importance of clarity and uniformity in state laws, made few variations in adopting the 1962 Official Text of the UCC as approved by

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[55] Vibbert v. Par, Inc., 224 S.W.3d 317, 321–22 (Tex. App.—El Paso 2006); *see also supra* notes 33–36 and accompanying text.

[56] *See supra* notes 33–36 and accompanying text; *see also* Rudd, *supra* note 35, at 968.

[57] *See supra* notes 33–45 and accompanying text.

[58] *See supra* Part II. Evidence of the legislature's intended deference to the UCC exists in overwhelming abundance: the UCC is the later and comprehensive act, the legislature repealed a number of the Texas CT law's conflicting provisions, and the legislature then inserted a savings clause (now § 501.005) to clear up any future confusion relating to the primacy of the UCC. *See* Rudd, *supra* note 35, at 968–69. *See also* the plain meaning of UCC §§ 9-109, 9-310, and 9-311. Even with this abundant evidence, confusion still exists in some courts over which law the court should apply. *See infra* Part III, Adoption of the UCOTA should be the legislature's next step, and hopefully last, in clarifying these intentions. *See infra* Part V.

[59] *See infra* notes 33-58 and accompanying text; *see also infra* notes 61–90 and accompanying text.

[60] Millard H. Ruud, *The Texas Legislative History of the Uniform Commercial Code*, 44 TEX. L. REV. 597, 597–600 (1966).

[61] *See supra* notes 33–58 and accompanying text.

[62] *See* Ruud, *supra* note 60, at 597–600.

[63] *Id*. at 597.

[64] *Id*. at 597–600. The legislation introduced from 1951-1965 ranged from a resolution to study the UCC to numerous recommendations for adoption. *Id*.

NCCUSL.[65] In his speech given at the Texas Institute on the Uniform Commercial Code on October 1, 1965, Professor Frederic K. Spies said that UCC Article 2 "in many ways remains the most conceptually perfect of any parts of the [UCC]."[66] It is UCC Articles 2 and 9 that vehicle purchasers rely on to assure and protect their ownership of the vehicle against claims including unknown secured parties.[67]

A Texas case has noted that, at least in part, the intent of the legislature in adopting the UCC was to shift this risk of loss.[68] In *Gallas v. Car Biz, Inc.*,[69] the appellant argued that the legislature intended to shift the loss to the car dealer based on principles of equity when the legislature enacted section 2.403 of the Texas UCC (section 2-403 in the uniform text). The court dismissed this argument, noting that it already had determined that the CT law controlled in the case.[70] However, based on the purposes of the UCC, the appellant's argument had merit.[71] Clearly, UCC section 2-403 "tends to favor the good faith purchaser over the original owner."[72]

"This theory is, of course, founded upon the public policy that protection should be afforded consumers in commercial transactions."[73] The UCC, in recognition of that public policy, favors a BIOCOB over the seller's secured party, and the Texas Legislature reinforced its belief in this public policy by inserting section 501.005 into the Texas CT law, reinforcing the primacy of the UCC in the event of a conflict between the two.[74] The *Gallas* court noted that "'[o]ne of the declared purposes of the [UCC] is to simplify, clarify, and modernize the law governing commercial transactions.'"[75] The court further described the UCC as a "general

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[65] *Id*. at 627. Texas has adopted a number of revisions to the UCC since adopting the 1962 Official Text in 1965. *See* JOHN E. KRAHMER, 12 TEX. PRAC. SERIES § 24.1, at 5 (3d ed. 2005). Articles 2 and 9 of the UCC are particularly relevant to the issues discussed in this article, and while the NCCUSL released a new version of Article 2 in 2003. Texas and most other states have yet to adopt it. *See id*. The Texas Legislature, however, did adopt the 1999 revised version of Article 9, which took effect in 2001. *See* TEX. BUS. & COM. CODE ANN. §§ 9.101-9.709 (West 2002).

[66] Frederic K. Spies, *Uniform Commercial Code: Article 2—Sales; Performance and Remedies*, 44 TEX. L. REV. 629, 644 (1966).

[67] *See* Vibbert v. PAR, Inc., 224 S.W.3d 317, 324 (Tex. App.—El Paso March 23, 2006, no pet. h.); Park Cities Ltd. P'ship. v. Trasnspo Funding Corp., 131 S.W.3d 654 (Tex. App.—Dallas 2004, no pet.); First Nat'l Bank of El Campo, TX v. Buss, 143 S.W.3d 915 (Tex. App.—Corpus Christi 2004, pet. denied); Hudson Buick, Pontiac, GMC Truck Co. v. Gooch, 7 S.W.3d 191 (Tex. App.—Tyler 1999, pet. denied); Gallas v. Car Biz, Inc., 914 S.W.2d 592, 594–95 (Tex. App.—Dallas 1995, writ denied); Morey v. Page, 802 S.W.2d 779 (Tex. App.—Dallas 1990, no writ); Pfluger v. Colquitt, 620 S.W.2d 739 (Tex. Civ. App.—Dallas 1981, writ ref'd n.r.e.).

[68] *Gallas*, 914 S.W.2d at 595.

[69] *Id*.

[70] *Id*.

[71] *See infra* notes 72–90.

[72] Krahmer, *supra* note 65, § 25.66, at 161.

[73] *Pfluger*, 620 S.W.2d 739, 743–47 (Stephens, J., concurring).

[74] *See* Krahmer, *supra* note 65, § 25.66, at 161; *see also supra* note 58 and accompanying text; U.C.C. § 9-320. Article 9 clearly has primacy over the CT law, except to the extent that Article 9 expressly defers to the CT law (as to the mechanics of perfection by a CT lien entry procedure). *See* U.C.C. §§ 9-102(a)(10), 9-109, 9-311(a). However, there is no similar UCC regime to address the relation between the CT law and UCC Article 2. As noted *infra* at Part IV., UCOTA solves this problem.

[75] Gallas v. Car Biz, Inc., 914 S.W.2d 592, 594 (Tex. App.—Dallas 1995, writ denied) (Wright J., dissenting)

body of law intended as a unified coverage of its subject matter . . . [and] some transactions in motor vehicles are expressly governed thereby."[76]

Two sections of the Texas UCC, sections 2.403 and 9.230 (sections 2-403 and 9-320 in the uniform text), deserve emphasis for the frequency with which they arise in Texas cases involving disputes over application of the UCC and the Texas CT law.[77] In enacting section 2.403, the legislature intended that the UCC "state a uniform and simplified policy on good faith purchase of goods," restating the better case law and the series of former uniform statutes that governed the law together in a consolidated location.[78]

Section 2.403(a) specifically provides for protection of a good faith purchaser for value.[79] This provision also follows the basic policy in the law, of allowing the transferor to transfer such ownership rights as he or she holds.[80] Moreover, section 2.403 applies to any form of purchase, and dispels past issues of contention by specifying that it applies even if: (1) the purchaser deceives the transferor as to the purchaser's identity; (2) a check is given in payment for the purchase and it is later dishonored; (3) an agreement existed that the transaction would be a cash sale; or (4) the delivery was procured through fraud, even if punishable under criminal law.[81] Section 2.403 also protects the buyer from a "reservation of property or other hidden interest" so long as that buyer is a BIOCOB, i.e., buying from a dealer's inventory.[82]

Moreover, the section 2.403 "entrustment" principle is carried beyond inventory to include a bailment, where the bailee deals in goods of the kind held.[83] This principle allows the BIOCOB to acquire greater rights than the seller (bailee) held at time of sale.[84] Thus, if the seller/bailee sells to a BIOCOB, the seller transfers all rights of the bailor in the property to the buyer.[85] Lastly, the drafters used the term "buyer in ordinary course of business" (BIOCOB) in order to provide protection for innocent buyers while allowing some flexibility to the court for cases outside the ordinary course of business.[86]

(quoting Assocs. Discount Corp. v. Rattan Chevrolet, Inc., 462 S.W.2d 546, 548 (Tex. 1970)).

[76] *Id*. (alterations in original) (quoting *Assocs. Discount Corp.*, 462 S.W.2d at 548 (citations omitted)).

[77] *See infra* Part III.

[78] TEX. BUS. & COM. CODE ANN. § 2.403 cmt. Purposes of Changes (West 1994).

[79] *Id*. § 2.403 cmt. 1.

[80] *Id*.

[81] *Id*.

[82] *Id*. § 2.403 cmt. 2. This principle makes complete sense from the standpoint of the party, be it a consignor or lender, who entrusted the goods to the seller because the apparent purpose of such a transaction is to sell the goods and convert them to cash. There can be no other common expectation when one delivers goods to a merchant who sells goods of that kind. *See id*.

[83] *Id*.

[84] Krahmer, *supra* note 65, § 25.66, at 162.

[85] *Id*.

[86] *See* TEX. BUS. & COM. CODE ANN. § 2.403 cmt. 3 (West 1994). In the entrustment context, "the transfer must be to a 'buyer in the ordinary course of business' and not merely to a good faith purchaser for value," Krahmer, *supra* note 65, § 25.66, at 162 (citation omitted). To find a situation like that of our Joe Consumer (*see supra* Part 1.), involving a good faith purchaser for value, to be outside the ordinary course of business, a court would have to act both unreasonably and unjustly.

Section 9.320 is the Article 9 version of this rule. It clarifies the circumstances where "a buyer of goods take[s] free of a security interest" even if that security interest is perfected.[87] This section should be understood in relation to Article 2 section 2.403, which contains general rules on the sale of goods subject to security interests.[88] The purpose underlying section 9.320 "is to allow ordinary course of business sales out of financed inventory."[89]

When all of this is applied correctly, courts hold that a BIOCOB obtains ownership of the vehicle free and clear of competing ownership claims of the seller and any bailee and entrustor, and any security interests created by the seller (such as an inventory loan), even absent a transfer of the CT, because the buyer's ownership interest is superior to that of the competing parties.[90] Seemingly, this policy is clear in the law, as expressly articulated in our national law of commerce, the UCC. How, then, can one explain the periodic confusion in the case law?

III. PRACTICE MAKES . . . WELL . . . NOT PERFECT: CONFLICTS IN THE TEXAS CASE LAW

A. Interpreting the Texas CT Law

The Dallas Court of Appeals (Dallas court) consistently (and erroneously) has applied the CT law in dealing with situations where a BIOCOB does not obtain execution of the CT covering the purchased vehicle, through some fault of the seller.[91] When this happens, the Dallas court has found that no sale occurred because the CT law requires that the CT be transferred at the time of sale.[92] In this view, if the dealer did not transfer the CT to the buyer at the time of sale, no sale occurred.[93] In such cases, the buyer often argues that, because section 501.005 of the CT law provides that "[c]hapters 1-9, [of the] . . . [UCC] control over

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[87] TEX. BUS. & COM. CODE ANN. § 9.320 cmt. 1 (West 2002).

[88] Krahmer, *supra* note 65, § 25.66, at 163; *see* TEX. BUS. & COM. CODE ANN. § 9.320 cmt. 1 (West 2002). The Texas Legislature did adopt an exception to section 9.320 in subsection (e) (also in the uniform text), providing that "[s]ubsection (a) and (b) do not affect a security interest in goods in the possession of the secured party under Section 9.313." *Id*. § 9.320(e). Also included in section 9.320 is a subsection for dealing with a buyer of oil, gas, and other minerals in the ordinary course of business. *Id*. § 9.320(d). The legislature could have also included an exception for vehicles, as it did for goods perfected under section 9.313 and for oil, gas, and other minerals, had it desired to protect the security interests on dealers' inventories or vehicles above all others. *Cf. id*. § 9.320(d)-(e) (West 2002).

[89] Krahmer, *supra* note 65, § 34.24, at 701.

[90] Vibbert v. PAR, Inc., 224 S.W.3d 317, 324 (Tex. App.—El Paso March 23, 2006, no pet. h.) (applying the UCC and protecting the buyer); First Nat'l Bank of El Campo, TX v. Buss, 143 S.W.3d 915 (Tex. App.—Corpus Christi 2004, pet. denied) (applying the UCC and protecting the buyer); Hudson Buick, Pontiac, GMC Truck Co. v. Gooch, 7 S.W.3d 191 (Tex. App.—Tyler 1999, pet. denied) (applying the UCC and protecting the buyer).

[91] *See* Park Cities Ltd. P'ship. v. Trasnspo Funding Corp., 131 S.W.3d 654 (Tex. App.—Dallas 2004, no pet.); Gallas v. Car Biz, Inc., 914 S.W.2d 592, 594–95 (Tex. App.—Dallas 1995, writ denied); Morey v. Page, 802 S.W.2d 779 (Tex. App.—Dallas 1990, no writ); Pfluger v. Colquitt, 620 S.W.2d 739 (Tex. Civ. App.—Dallas 1981, writ ref'd n.r.e.) (UCC).

[92] *See Park Cities Ltd. P'ship.*, 131 S.W.3d at 659–60; *Gallas*, 914 S.W.2d at 594; *Morey*, 802 S.W.2d at 783; *Pfluger*, 620 S.W.2d at 741.

[93] *See Park Cities Ltd. P'ship.*, 131 S.W.3d at 659–60; *Gallas*, 914 S.W.2d at 594; *Morey*, 802 S.W.2d at 783; *Pfluger*, 620 S.W.2d at 741. Aside from the fact that this is contrary to law (as noted below), this is blatantly unfair to the buyer, since execution of the CT is within the control of the seller and the common practice in dealer sales is to defer transfer of the CT until after the sale.

conflicting provisions of this chapter," the UCC controls these cases.[94] However, the Dallas court has answered that since sections 2.401(b), 2.403(a), and 9.320 of the UCC refer to a "purchaser" and a "buyer" respectively, a "'sale' or 'other voluntary transaction creating an interest in the property'" is required to make someone a purchaser or a buyer and to trigger application of the two provisions of the UCC pursuant to section 501.005 of the CT law.[95] Since the Dallas court has concluded that without transfer of the CT no sale occurs, it also has concluded that the relevant provisions of the UCC (intended to protect buyers in this scenario) are not applicable because they only apply in the event of a sale.[96]

Gallas is an example of the Dallas court's application of this reasoning. In *Gallas*, a licensed car dealership, Car Biz, sold a motor vehicle to a used car dealer, Stamper.[97] Stamper issued Car Biz a sight draft for the vehicle, a 1992 Ford Explorer, and Car Biz allowed Stamper to take possession of the vehicle.[98] Car Biz did not execute or deliver the CT to the buyer (Stamper) at the time of the sale, but as is customary began the process of transferring

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[94] *See Park Cities Ltd. P'ship.*, 131 S.W.3d at 659–60; *Gallas*, 914 S.W.2d at 594; *Morey*, 802 S.W.2d at 783; *Pfluger*, 620 S.W.2d at 741.

[95] This is clearly an incorrect application of the law to these facts, as the UCC defines such terms as "purchase" and "sale" to include transactions intended to pass title in the future, as well as immediate transfers of ownership. *See* U.C.C. § 2-401 (excerpted below). Moreover, the definition of "[b]uyer in ordinary course of business" at § 1-201(b)(9) (Texas § 1.201(b)(9)) defines that term by reference to customary practices in the industry, and does not require an immediate passage of title. *See supra* note 14; *see also* TEX. BUS. & COM. CODE ANN. § 2.401(b) (West Supp. 2007); TEX. BUS. & COM. CODE ANN. § 2.403(a) (Vernon 1994); *Park Cities Ltd. P'ship.*, 131 S.W.3d at 659–60. Section 2.401(b) of the Texas Business and Commerce Code states:

> Unless otherwise explicitly agreed title passes to the buyer at the time and place at which the seller completes his performance with reference to the physical delivery of the goods, despite any reservation of a security interest and even though a document of title is to be delivered at a different time or place . . . .

TEX. BUS. & COM. CODE ANN. § 2.401(b) (West Supp. 2007). Section 2.403(a) of the Texas Business and Commerce Code states:

> a) A purchaser of goods acquires all title which his transferor had or had power to transfer except that a purchaser of a limited interest acquires rights only to the extent of the interest purchased. A person with voidable title has power to transfer a good title to a good faith purchaser for value. When goods have been delivered under a transaction of purchase the purchaser has such power even though
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> 1. the transferor was deceived as to the identity of the purchaser, or
>
> 2. the delivery was in exchange for a check which is later dishonored, or
>
> 3. it was agreed that the transaction was to be a "cash sale", or
>
> 4. the delivery was procured through fraud punishable as larcenous under the criminal law.

TEX. BUS. & COM. CODE ANN. § 2.403(a) (West1994).

[96] *See Park Cities Ltd. P'ship.*, 131 S.W.3d at 659–60; *Gallas*, 914 S.W.2d at 594; *Morey*, 802 S.W.2d at 783; *Pfluger*, 620 S.W.2d at 741; *see supra* this text Part II. Note that, among other problems with this view, it ignores the applicable definition of "sale" in UCC Article 2. *See, e.g.*, U.C.C. § 2-401; *supra* note 95.

[97] *See Gallas*, 914 S.W.2d at 592–93.

[98] *Id*. at 593.

the CT to Stamper.[99]

Stamper sold the vehicle three days later to Gallas for $14,000, which Gallas paid to Stamper.[100] Gallas filled out an application for a CT, relying on Stamper's representation that the CT was "in transit or in transfer," and received possession of the vehicle.[101] Before the Texas Department of Transportation performed any CT transfer, Car Biz's bank informed it that Stamper's draft had been dishonored; therefore, Car Biz did not complete the CT transfer.[102] Car Biz reported the vehicle stolen, resulting in Gallas's arrest, and then applied for and received a new CT.[103] Gallas filed an action seeking a declaration that he owned the vehicle and specific performance of the ownership transfer, along with asserting other claims in conversion and estoppel.[104] Car Biz counterclaimed for a declaration of ownership and possession of the vehicle.[105] The trial court granted Car Biz's motion for judgment notwithstanding the verdict, declaring Car Biz the owner and ordering Gallas to deliver the vehicle to Car Biz.[106]

The Dallas court, in reviewing Car Biz's motion for judgment notwithstanding the verdict, addressed application of the Texas CT law and the UCC, as well as the applicable case law precedent.[107] Car Biz argued that, pursuant to the Texas CT law, Stamper did not have "good title" because he had not obtained execution of the CT and, therefore, Stamper could not pass ownership to Gallas.[108] Gallas responded that section 2.403(b) of the UCC controls the passage of ownership.[109] He argued that Car Biz entrusted the vehicle to Stamper giving Stamper "the power to transfer all rights in the vehicle . . . ."[110]

The Dallas court noted that in *Morey v. Page* and *Pfluger v. Colquitt*[111] the court had addressed the same issue. Quoting *Pluger*, the Dallas court interpreted section 2.403(b) of the

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[99] *Id.*

[100] *Id.*

[101] *Id.*

[102] *Id.*

[103] *Id.*

[104] *Id.*

[105] *Id.*

[106] *Id.*

[107] *Id.* at 594–95.

[108] *Id.* at 594; *see also* Tex. Transp. Code Ann. §§ 501.071, .073 (Vernon 2007).

[109] *See Gallas*, 914 S.W.2d at 594. Section 2.403(b) of the Texas Business and Commerce Code. Texas's adopted version of section 2-403(2) of the UCC, states: "Any entrusting of possession of goods to a merchant who deals in goods of that kind gives him power to transfer all rights of the entruster to a buyer in ordinary course of business." TEX. BUS. & COM. CODE ANN. § 2.403(b) (West 1994).

[110] *See Gallas*, 914 S.W.2d at 594.

[111] *Id.; see generally* Morey v. Page, 802 S.W.2d 779, 783–84 (Tex. App.—Dallas 1990, no writ) (finding that the Texas CT law controls a transaction for motor vehicles without proper transfer of title); Pfluger v. Colquitt, 620 S.W.2d 739, 741–42 (Tex. Civ. App.—Dallas 1981, writ ref'd n.r.e.) (determining that the Texas CT law limits the power to transfer ownership of a vehicle, and controls). Interestingly, both *Pfluger* and *Morey* relied primarily on agency law to determine the Texas CT law to be controlling. *See Morey*, 802 S.W.2d at 783-84; *Pfluger*, 620 S.W.2d at 741-42.

Texas UCC as giving to the merchant the same rights to transfer which the entruster had.[112] However, the Dallas court further concluded that the Texas CT law is a limit on this power of the entruster; if the person entrusting the property to the merchant did not have the ownership required to sell the vehicle, then the merchant cannot sell the vehicle either.[113] The Dallas court then held that "because [*Gallas*] involves the sale of a motor vehicle without proper transfer of the certificate of title . . . it is, likewise, governed by the [CT law]."[114] The Dallas court responded in a circular manner to Gallas's assertion that the legislature, in enacting section 2.403, intended to shift the burden of this loss to parties in Car Biz's position, stating that the court already had determined that the Texas CT law controlled. The court then stated that Gallas was free to pursue a cause of action against Stamper.[115]

Gallas is striking in its misapplication of the plain meaning of the UCC and for disregarding the clear intent of the legislature, and was the subject of a strong dissenting opinion. In the dissent, Justice Wright began by noting the provision of the Texas CT law stating that the UCC controls "in instances where the [UCC] and the [Texas CT law] conflict."[116] Justice Wright concluded that, under sections 2.401 and 2.403(a)-(b) of the Texas UCC, Gallas should recover based upon the jury's fact-findings with regards to those sections.[117] Justice Wright noted that the majority did not discuss these sections because the majority felt that addressing those sections of the UCC would be improper since Gallas did not specifically assert them on appeal; however, Justice Wright noted that Gallas asserted the applicability of the UCC on appeal, and concluded that a failure to cite specific sections amounted to a failure to cite a specific piece of authority rather than the failure to raise an issue on appeal.[118]

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[112] *Gallas*, 914 S.W.2d at 594 (quoting *Pfluger*, 620 S.W.2d at 741–42).

[113] *Id*. (quoting *Pfluger*, 620 S.W.2d at 741–42). Note that, while it may be true as a general principle that the entrustment rule only transfers the rights of the entruster, in this case Car Biz was the owner/entruster and clearly transferred its ownership rights to Stamper under UCC Article 2.

[114] *Gallas*, 914 S.W.2d. at 595.

[115] *Id*. This is clearly beside the point and inferior to the remedy provided by the UCC and intended by the legislature. Moreover, the *Gallas* court relied on a case stating (contrary to the decision in *Gallas*) that "a sale between the parties is not rendered void by non-compliance with the [CT law]." *Id*. (citing Cash v. Lebowitz, 734 S.W.2d 396, 398 (Tex. App.—Dallas 1987, writ ref'd n.r.e.). By this reasoning, the *Gallas* court should have found that the sale to Gallas was "not rendered void by non-compliance with the [CT law]," that Gallas was therefore a buyer protected under UCC Article 2, and that Car Biz could pursue a remedy against Stamper. *Id*. (citing *Cash*, 734 S.W.2d at 398). The *Gallas* court seemed to find comfort in the fact that an avenue for recovery remained available to Gallas via Stamper; but if the sale was valid between the parties, as the court claimed, then the court should have held that Gallas was protected as the purchaser. *See id*. Undoubtedly, if the court found for Gallas, Car Biz would have pursued its remedy against Stamper. Moreover, this result would properly reflect that Car Biz was the party at fault, not Gallas.

[116] *Id*. (Wright, J. dissenting); *see also* TEX. TRANSP. CODE ANN. § 501.005 (West 2007).

[117] *Gallas*, 914 S.W.2d at 596 (Wright, J. dissenting). Regarding sections 2.401 and 2.403 of the Texas UCC, the jury found:

> (1) Stamper purchased the vehicle from [Car Biz]; (2) [Car Biz] delivered the vehicle to Stamper under a purchase transaction; (3) [Car Biz] entrusted possession of the vehicle to Stamper; (4) Stamper was a merchant who dealt in the business of used automobiles; (5) [Gallas] was a buyer in the ordinary course of business.

Id. at 593.

[118] *Id*. at 596 (Wright, J. dissenting).

Justice Wright noted that, under Texas UCC section 2.401, once the seller physically completes delivery of the goods, ownership passes to the buyer regardless of the subsequent delivery of related documentation.[119] Justice Wright then noted that Texas UCC section 2.403(a) provides that delivery of goods as part of a purchase transaction provides the purchaser power to transfer ownership to a good faith purchaser even when the goods are exchanged for a draft that is later dishonored.[120] Justice Wright concluded that a seller transfers ownership under section 2.403(b) when he or she intends to transfer all of the entruster's rights.[121] Accordingly, if the Texas CT law provides a different outcome, then an apparent conflict exists between the UCC and the Texas CT law; therefore, according to the express language of the Texas CT law, the UCC controls because there is a conflict with the CT law.[122]

Justice Wright then applied the law to the facts of *Gallas*.[123] The Texas CT law provides that the UCC controls in cases of conflict, and UCC sections 2.401, 2.403(a), and 2.403(b) indicate that vehicle sales in Texas are not controlled exclusively by the Texas CT law.[124] In applying section 2.403(b), Justice Wright determined that the basic issue to be decided in the case was the extent of Car Biz's rights under the UCC when Car Biz gave possession to Stamper.[125] Once Car Biz delivered the vehicle to Stamper, under Texas UCC section 2.401 the ownership passed to Stamper regardless of whether Car Biz delivered the CT at a later time.[126] Thus, Stamper could transfer that ownership to a good faith purchaser even if the bank dishonored his draft to Car Biz.[127] Stamper acquired the ownership and passed that ownership to Gallas regardless of Stamper's failure to receive or deliver the CT at the time of sale.[128]

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[119] *Id*. at 596–97 (Wright, J., dissenting); *see* TEX. BUS. & COM. CODE ANN. § 2.401 (West Supp. 2007); *see supra* note 95 (full text of section 2.401(b) of the Texas UCC).

[120] *Gallas*, 914 S.W.2d at 596–97 (Wright, J., dissenting); *see* TEX. BUS. & COM. CODE ANN. § 2.403(a) (West 1994); *see supra* note 95 (full text of section 2.403(a) of the Texas UCC).

[121] *Gallas*, 914 S.W.2d at 596–97 (Wright, J., dissenting); *see* TEX. BUS. & COM. CODE ANN. § 2.403(b) (West 1994); s*ee supra* note 109 (full text of section 2.403(b) of the Texas UCC).

[122] *See* TEX. TRANSP. CODE ANN. § 501.005 (West 2007); *Gallas*, 914 S.W.2d at 596, 600 (Wright, J., dissenting) ("A statutory interpretation which attempts to harmonize these provisions necessarily admits there is a conflict between them.").

[123] *Gallas*, 914 S.W.2d at 596–601.

[124] *Id*. at 598 (Wright, J., dissenting); *see* TEX. BUS. & COM. CODE ANN. § 2.401 (West Supp. 2007); *id*. § 2.403(a)-(b) (West1994); TEX. TRANSP. CODE ANN. § 501.005 (West 2007).

[125] *Gallas*, 914 S.W.2d at 598 (Wright, J., dissenting); *see* TEX. BUS. & COM. CODE ANN. § 2.403(b) (West 1994); *supra* note 121 and accompanying text. Car Biz's rights are the rights that pass to Stamper. *See Gallas*, 914 S.W.2d at 598 (Wright, J., dissenting).

[126] TEX. BUS. & COM. CODE ANN. § 2.401 (West 2011); *see also Gallas*, 914 S.W.2d at 598 (Wright, J., dissenting). Despite what the majority says, this section is in direct conflict with the part of the Texas CT law purporting to require transfer of the CT for a sale. *Compare* TEX. TRANSP. CODE ANN. § 501.071 (West 2011) (providing that a sale requires a transfer of the CT), *with* TEX. BUS. & COM. CODE ANN. § 2.401 (West 2011) (providing that ownership passes with physical delivery of the goods).

[127] *See* TEX. BUS. & COM. CODE ANN. § 2.403(a) (West 2011); *see also Gallas*, 914 S.W.2d at 598 (Wright, J., dissenting).

[128] *See* discussion *supra* notes 116–19 and accompanying text.

In his dissent, Justice Wright distinguished the cases relied upon by the majority.[129] First, he noted that *Pfluger* is distinguishable on its facts.[130] While *Boswell* and *Morey* are nearly identical factually to *Gallas*, he observed that both cases similarly misapplied the law.[131]

The law clearly supports Justice Wright's position.[132] *Gallas* relied heavily upon resolution of the conflict between the Texas CT law and the UCC as addressed in *Pfluger*, but the *Pfluger* court applied these laws incorrectly. The *Pfluger* majority relied on a principle of statutory construction which provided that the court had a duty "to interpret statutory language so as to harmonize apparently conflicting provisions and give effect to each in light of its purpose, if such an interpretation [was] reasonable."[133]

However, the *Pfluger* court failed to properly complete the analysis for two reasons: First, the cases upon which the *Pfluger* court relied for the governing principle looked at whether the legislature intended, by its actions, to change the previous public policy of the state; yet, the *Pfluger* court never considered this in the context of the Texas CT law and its relation to the UCC.[134] Second, none of the statutes considered in support of the statutory principle applied by the *Pfluger* majority contained intra-state preemption clauses.[135] In this situation, the reverse-preemption clause in section 501.005 of the Texas CT law creates additional support for Justice Wright's position, because the majority, by harmonizing in an effort to honor the intent of both laws, contradicted the clear legislative intent, namely to give effect to the UCC, as expressed by the reverse-preemption clause in section 501.005 of the Texas CT law.[136]

Additionally, the *Pfluger* court did not consider the legislature's purpose in placing the reverse-preemption clause in the CT law—the legislature precisely intended to change the public policy surrounding auto sales to reflect the principles of the UCC.[137] Because the *Pfluger* court did not consider these factors, that court's attempt to harmonize the laws did not

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129 *Gallas*, 914 S.W.2d at 598 (Wright, J., dissenting).

130 *Id.*; *see generally* Pfluger v. Colquitt, 620 S.W.2d 739 (Tex. Civ. App.—Dallas 1981, no writ) (discussing the relationship between the Texas CT law and the UCC, but ultimately relying on the finding of a principal-agent relationship in finding the Texas CT law controlling).

131 *Gallas*, 914 S.W.2d at 599–600 (Wright, J., dissenting); *see generally* Boswell v. Connell, 556 S.W.2d 624 (Tex. Civ. App.—Beaumont 1977, writ ref'd n.r.e.) (misapplying both the Texas CT law and *Pfluger*, because *Pfluger* merely discussed the Texas CT law and the UCC, then ultimately relied on the agency relationship for its holding); *see also* Morey v. Page, 802 S.W.2d 779 (Tex. App.—Dallas 1990, no writ) (misapplying *Pfluger*).

132 *See* discussion *supra* notes 116–30 and accompanying text.

133 *Pfluger*, 620 S.W.2d at 741.

134 *Id*. (citing State v. Standard Oil Co., 107 S.W.2d 550, 559 (Tex. 1937); County of Harris v. Tenn. Prods. Pipe Line Co., 332 S.W.2d 777, 781 (Tex. Civ. App.—Houston 1960, no writ)).

135 *Id*. (citing *Standard Oil Co.*, 107 S.W.2d at 559; *Tenn. Prods. Pipe Line Co.*, 332 S.W.2d at 781). In fact, Texas CT law § 501.005 is somewhat unusual among state CT laws, although it merely restates what should already be the law. This should make these cases easy to decide in Texas, and it is instructive that (as described in this article) experience is to the contrary. Given these problems, even in the face of § 501.005, one can only wonder at the problems that await cases in other jurisdictions without an equivalent to § 501.005. UCOTA, of course, resolves these problems. *See infra* Part IV.

136 *See Pfluger*, 620 S.W.2d at 741–42.

137 *See id*.

eliminate the conflict between the laws.[138] The *Gallas* majority's adoption of this reasoning led it similarly astray.[139]

In discussing Texas UCC section 2.401, Justice Wright noted that the legislature provided instructions in the event of a conflict between the UCC and the Texas CT law, and "[a] statutory interpretation which attempts to harmonize [them] necessarily admits there is a conflict . . . [and] is erroneous."[140] The express language of the UCC provides that "title passes to the buyer when the seller completes . . . physical delivery."[141] There is no mention of other limits on the "'rights of the seller"' as the basis for a transfer of ownership under section 2.401; therefore, the Texas CT law does not limit the seller's power to transfer ownership.[142] Justice Wright properly concluded that the express language of the Texas UCC in section 2.401 should have entitled Gallas to recover when applied to the jury's finding that Stamper sold and physically delivered the vehicle to Gallas."[143]

Lastly, Justice Wright applied Texas UCC section 2.403(a) to *Gallas*.[144] In addition to section 2.401, he noted that the majority also ignored section 2.403(a).[145] The jury determined that Car Biz, Inc. delivered the vehicle to Stamper, who was a merchant purchasing the goods in a "transaction of purchase."[146] Because the jury determined Gallas to be a BIOCOB, Stamper also transferred ownership to Gallas under section 2.403(a).[147] Ultimately, Justice Wright stated that the UCC controlled and entitled Gallas to recover "upon the application of the jury's fact-findings to section 2.403(a)."[148]

The Dallas court thus reflected two very different views in *Gallas*: (1) the framing of the view in favor of settling this conflict entirely under the Texas CT law;[149] and (2) the view of Justice Wright, recognizing application of the UCC, in the dissent.[150] Ultimately, the view Justice Wright expressed in the *Gallas* dissent became the majority in a later El Paso Court of Appeals (El Paso court) case.[151] Justice McClure, writing for the majority of the El Paso court in *Vibbert v. PAR, Inc.*,[152] applied reasoning very similar to that of Justice Wright's dissent in

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138 *Id*.

139 Gallas v. Car Biz, Inc., 914 S.W.2d 592, 594–95 (Tex. App.—Dallas 1995, writ denied) (majority opinion).

140 *Id*. at 600 (Wright, J., dissenting).

141 *Id*. (Wright, J., dissenting) (citing TEX. BUS. & COM. CODE ANN. § 2.401 (West 2011)).

142 *Id*. (Wright, J., dissenting) (citing TEX. BUS. & COM. CODE ANN. § 2.401 (West 2011)).

143 *See Id*. (Wright, J., dissenting).

144 *Id*. at 600–01 (Wright, J., dissenting).

145 *Id*. at 600 (Wright, J., dissenting) (quoting TEX. BUS. & COM. CODE ANN. § 2.401 (West 2011) (stating that the validity of a draft does not impact the power of a person with voidable title to transfer good title to a good faith purchaser in a purchase transaction); TEX. BUS. & COM. CODE ANN. § 2.403(a) (West 2011).

146 *Id*. (Wright, J., dissenting) (quoting TEX. BUS. & COM. CODE ANN. § 2.403(a) (West 2011)).

147 *Id*. (Wright, J., dissenting).

148 *Id*. (Wright, J., dissenting).

149 *Id*. at 594–95 (majority opinion).

150 *Id*. at 595–601 (Wright, J. dissenting).

151 *See id*. (Wright, J. dissenting); *cf*. Vibbert v. PAR, Inc., 224 S.W.3d 317 (Tex. App.—El Paso 2006, no pet.) (applying the *Gallas* dissent's reasoning); *see* discussion *infra* notes 152–73 and accompanying text.

152 224 S.W.3d 317, 317 (Tex. App.—El Paso 2006, no pet. h.).

Gallas. This analysis as applied in *Vibbert* serves as a good example of how various other Texas appellate courts have held that the buyer is protected under the UCC, rejecting the erroneous precedent set by the Dallas court.

B. Cases Holding the Buyer Protected Under the UCC

As noted, other Texas appellate courts using Justice Wright's reasoning have held that the reverse-preemption provision in the CT law applies and, as a result, the controlling statute is the UCC.[153] Thus, the El Paso court in *Vibbert* acknowledged the CT law, but found the UCC controlling.[154]

In *Vibbert*, Sandra and Joseph Vibbert traded in their 1998 Nissan Altima to G.S. Motor Sports (G.S.) to supplement the purchase of a 1989 Mercedes Benz.[155] G.S. agreed to pay off the loan balance owed on the Altima.[156] G.S. sold the car a few days later to the Kuwamotos, who contacted Zoom Lot Funding (Zoom) to finance the purchase.[157] Approximately one month later, Wells Fargo Bank (Wells Fargo), the Vibberts' secured creditor for the Altima, contacted the Vibberts and notified them that it had received no payment for the secured debt owed on the Altima.[158] Sandra Vibbert contacted Gary Swenson, the owner of G.S., and obtained a copy of the payoff check.[159] Ms. Vibbert then discovered that the G.S. check had bounced and thus G.S. had never paid off the secured debt owed to Wells Fargo.[160] The vehicle was subsequently repossessed by PAR. The Vibberts then filed suit against PAR—a company specializing in repossessing vehicles for secured parties—to assert their superior interest in the vehicle and allege conversion.[161]

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[153] *See id*. at 324; *see also* TEX. TRANSP. CODE ANN. § 501.005 (West 2011); First Nat'l Bank of El Campo, TX v. Buss, 143 S.W.3d 915, 915 (Tex. App.—Corpus Christi 2004, pet. denied); Hudson Buick, Pontiac, GMC Truck Co. v. Gooch, 7 S.W.3d 191, 191 (Tex. App.—Tyler 1999, pet. denied). Note that while this is the correct result, it is not the correct reasoning. At least in cases involving UCC Article 9, the law governing these scope issues is Article 9, not the CT law. *See* U.C.C. § 9-109 (2001) (Article 9 governs security interest issues); *see also* U.C.C. § 9-311(a) (limited exception for perfection under the CT law, but not for priority and related issues).

[154] *See* U.C.C. §§ 9-109, 9-311; *see also Vibbert*, 224 S.W.3d at 324.

[155] *Id*. at 318.

[156] *Id*.

[157] *Id*. at 318–19.

[158] *Id*. at 319.

[159] *Id*.

[160] *Id*. In another suit, Ms. Vibbert sued G.S. and owner Gary Swenson.

[161] *Id*. at 319–20. Because G.S. never paid off the loan, the Vibberts were still indebted to Wells Fargo. If they could not claim ownership of the vehicle, they would lose the value of the vehicle *and* would have liability to Wells Fargo for the outstanding balance of the debt. *Id*. at 318–19. Potentially, the Vibbert's could reclaim this amount in the suit filed against G.S.; however, if G.S. was insolvent the Vibberts would be near the back of the line in making claims in bankruptcy and would likely be left with little or no prospect of recovery. *See* 11 U.S.C. § 507 (2006) (priorities in bankruptcy*); Id*. at 319. Additionally, although not discussed in *Vibbert*, state law required G.S. to "obtain a $25,000 surety bond from an approved surety to guarantee (1) its payment of all valid bank drafts drawn by it to buy motor vehicles . . . " Gramercy Ins. Co. v. Arcadia Fin. Ltd., 32 S.W.3d 402, 405 (Tex. App.—Houston [14th Dist.] 2000, no pet.). Potentially, if this fund were not previously drained by parties closer to the front of the line, the Vibberts could seek recovery through this statute. *See* TEX. TRANSP. CODE ANN. § 503.033 (West 2011).

Roughly six months after the sale of the Altima to the Kuwamotos, Cygnet, the parent company of Zoom, had contacted PAR.[162] PAR's CT department customarily acquires a duplicate CT, or repossession CT, for its customers, in order to effect a secured party's repossession.[163] In this instance, Cygnet provided PAR with the relevant documents regarding the sale of the Altima to the Kuwamotos and the security interest held by Zoom, preparatory to the repossession; nowhere in this documentation was there an indication that any interest in the vehicle was held by the Vibberts or Wells Fargo.[164] PAR then hired another company, C & M Title Services, to obtain a certified copy of the Altima's Texas CT, which showed Sandra Vibbert as the record owner and Wells Fargo as the secured party; however, this information was never shared with PAR.[165] C & M Title Services then filed an application to transfer the CT from the Vibberts to the Kuwamotos; the record was unclear exactly how this was done, and exactly who signed the names of Ms. Vibbert and her secured party to the CT application.[166]

Each of these parties claimed the right of ownership and possession under different laws.[167] The Vibberts claimed that, under the Texas CT law, the sale from Sandra Vibbert to G.S. was void because Sandra Vibbert never transferred the CT; therefore, they claimed that possession of the Altima rightfully belonged with the Vibberts.[168] PAR argued that, pursuant to the UCC, ownership of the Altima passed upon Sandra's sale and physical delivery of the vehicle to the dealer, terminating Sandra's rights of ownership and possession.[169] The *Vibbert* court examined the nature and purposes of both laws, noting that the purpose of the CT law "is not to prevent sales and transfers of interests in motor vehicles."[170]

After discussing the interplay between the purposes of these laws and their conflicts,

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[162] *Vibbert*, 224 S.W.3d at 319.

[163] *Id*.

[164] *Id*.

[165] *Id*. The actual secured party indicated on the CT was Norwest Bank El Paso, but prior to the case the security interest was assigned to Wells Fargo Bank. *See id*. at 318–19. This may raise other issues. *See, e.g.*, Alvin C. Harrell, *Does a Secured Party's Assignment or Change of Name or Entity Require a New Certificate of Title?*, 63 CONSUMER FIN. L.Q. REP. 114 (2009).

[166] *Vibbert*, 224 S.W.3d at 319. The release of the security interest held by Wells Fargo "was purportedly signed by Brenda Bodkin, a PAR supervisor, as agent for [Wells Fargo]." *Id*. The company hired by PAR, C & M Title Services, denied that there was any forgery in the application. *Id*.

[167] *Id*. at 321. The trial court granted PAR's traditional and no evidence summary judgment motions without denoting the foundation for its ruling, leading to this appeal. *Id*. at 319–20.

[168] *Id*. at 321.

[169] *Id*.

[170] *Id*.; *see generally* discussion *supra* Part II B-C. (discussing the nature and purposes of the Texas CT law and UCC). In *Vibbert*, the El Paso court also noted a distinct conflict in the way a transfer of ownership relates to completion of a sale. *Id*. at 322. Under the UCC, "a 'sale' consists of the 'passing of title from the seller to the buyer for a price' (Section 2.401)." *Id*. (quoting TEX. BUS. & COM. CODE ANN. § 2.106(a) (West 2011)). The UCC also states that, regardless of any reservation of a security interest or the CT being delivered at another time or place, ownership passes to the buyer immediately upon the seller's completion of physical delivery of the goods. *Id*. (citing TEX. BUS. & COM. CODE ANN. § 2.401(b) (West 2011)). Under the CT law, however, a sale that violates Chapter 501 of the Texas Transportation Code "is void and title may not pass until the requirements of the chapter are satisfied." *Id*. (citing TEX. TRANSP. CODE ANN. § 501.073 (West 2011)).

Justice McClure discussed the Vibberts' reference, at the oral argument, to the *Gallas* case. In *Gallas*, as noted above, the Dallas court held that the Texas CT law controlled, but Justice McClure concluded in *Vibbert* that the proper interpretation was Justice Wright's dissent in *Gallas*.[171] While the *Gallas* majority held that no conflict existed between the two laws because under the CT law no sale occurred. Justice Wright noted that this is contrary to the UCC, and "[a] statutory interpretation which attempts to harmonize these provisions necessarily admits there is a conflict between them."[172]

The *Gallas* majority held that an interpretation harmonizing the CT law and the UCC, as the Dallas court purported to do in both *Pfluger* and *Morey*, "obviates the necessity to resort to section [501.005] of the [CT law] to resolve any apparent conflict."[173] However, in *Vibbert* the El Paso court agreed with Justice Wright that a conflict exists between the two laws. The decision in *Vibbert*, applying the reasoning of Justice Wright's dissent, ultimately favored PAR, affirming the trial court's grant of summary judgment and declaring that Sandra Vibbert transferred ownership when she delivered the Altima to G.S. as part of the purchase of her Mercedes Benz, and her failure to transfer the Altima's CT did not void the sale.[174] The El Paso court "conclude[d] that there is a conflict between . . . the [UCC] and . . . the [CT law]"; and that, by the Texas CT law's express language, the UCC has primacy when a conflict exists between the two.[175]

Other courts of appeals in Texas, with the exception of the Dallas court, have reached the same conclusion as the El Paso court in *Vibbert*, in cases with related, though different, sets of facts.[176] The Corpus Christi Court of Appeals (Corpus Christi court), in *First Nat'l Bank of El Campo, Tex. v. Buss*,[177] held that "the [Texas CT law] and the [UCC] conflict with regard to when legal title passes under the circumstances presented . . . and . . . provisions of the [UCC] control to establish the relative rights of a floor-plan financier and a purchaser of a used vehicle from a dealer." Similarly, in *Gramercy Ins. Co. v. Arcadia Fin. Ltd.*,[178] the Houston

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[171] *Id*. at 321–24. The court also noted Justice Stephens's concurrence in *Pfluger*, which Justice Wright cited in his dissent in *Gallas. Id*. (citing Pfluger v. Colquitt, 620 S.W.2d 739, 747 (Tex. Civ. App.—Dallas 1990, no writ) (Stephens, J., concurring)); *see also* Gallas v. Car Biz, Inc., 914 S.W.2d 592, 595 (Tex. App. —Dallas 1995, writ denied) (Wright, J., dissenting).

[172] *Vibbert*, 224 S.W.3d at 321–24 (quoting *Gallas*, 914 S.W.2d at 600 (Wright, J., dissenting)).

[173] *Gallas*, 914 S.W.2d at 595 (Wright, J., dissenting). The *Gallas* court referred to the conflict as "apparent," yet insisted that no conflict exists. *See id*. This was probably intended to suggest a "false" conflict, i.e., one that apparently exists but upon analysis is resolved by harmonization. But, as illustrated here, in this instance the conflict is real and to the extent it can be harmonized by using § 501.005, the Dallas court did so incorrectly.

[174] *Vibbert*, 224 S.W.3d at 324; *see* discussion *supra* notes 153–73.

[175] This is clearly the correct result. *See Vibbert*, 224 S.W.3d at 324. *But see supra* note 153.

[176] *See* discussion *infra* notes 178-82 and accompanying text.

[177] First Nat'l Bank of El Campo, Tex. v. Buss, 143 S.W.3d 915, 923–24 (Tex. App.—Corpus Christi 2004). The basic facts of *El Campo* are as follows: Over several separate transactions, the buyers purchased and took possession of the cars from the used car dealer, Dota, filled out the CT applications, and left them with Dota, who never completed the applications. *Id*. at 916–17. The dealer defaulted on its promissory note and the floor-plan lender made a demand to return the vehicles on both the dealership and the buyers. *Id*. The dealer, however, filed bankruptcy, and the buyers each filed suit to clarify the ownership. *Id*.

[178] Gramercy Ins. Co. v. Arcadia Fin. Ltd., 32 S.W.3d 402, 408 (Tex. App.—Houston [14th Dist.] 2000) (quoting Phil Phillips Ford, Inc. v. St. Paul Fire & Marine Ins. Co., 465 S.W.2d 933, 937 (Tex. 1971) (overruled on

court stated: "[E]ven in the face of non-compliance [with the Texas CT law], the sale of a vehicle without the transfer of a title certificate [the CT] is valid 'as between the parties, when the purposes of the Certificate of Title Act [CT law] are not defeated, although the Act [CT law] declares that the non-transfer of such certificates [CT] renders the sale void.'"[179] The Tyler Court of Appeals, in *Hudson Buick, Pontiac, GMC Truck Co. v. Gooch*,[180] noted the change in the law following the decision in *Phil Phillips Ford, Inc. v. St. Paul Fire & Marine Ins*. when the court stated: "[T]he legislature amended the [Texas CT law] to include section 65 [now section 501.005,] which stated that the [UCC] controlled if there was a conflict with the [Texas CT law]."[181]

Thus, most but by no means all, Texas courts have held that a conflict exists between the Texas CT law and UCC on these issues, and that courts should apply the UCC to these situations, protecting the buyer over the rights of the seller's security party.[182] However, the analysis remains murky and unsettled, as illustrated by this Texas case law, even in the face of

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other points of law by statute)). In *Gramercy*, the "[l]ender for an automobile dealership brought action against surety to recover on dealer's bond after the lender obtained a default judgment against the dealer for failing to repurchase installment contracts." *Id*. at 402. For a discussion of the purposes of the Texas CT law, *see supra* Part II A.

[179] *Gramercy*, 32 S.W.3d at 408 (quoting *Phillips Ford*, 465 S.W.2d at 937.).

[180] Hudson Buick, Pontiac, GMC Truck Co. v. Gooch, 7 S.W.3d 191, 198 (Tex. App.—Tyler 1999, pet. denied) (citing Act of May 10, 1971, 62nd Leg., R.S., ch. 123, *reprinted in* 1971 Tex. Gen. Laws 895, 896 (West 2007) (recodified as TEX. TRANSP. CODE ANN. § 501.005 (West 2011) by Acts 1995, 74th Leg., ch. 165, § 1, eff. Sept. 1, 1995)). In *Hudson*, Newton Hudson, the owner of the Hudson Buick, Pontiac, GMC Truck Company, agreed to sell four vehicles to Don Shirley, an automobile wholesaler who purchased the cars on behalf of Cars of Texas. *Hudson*, 7 S.W.3d at 193. Shirley only paid a portion of the amount owed to Hudson, but signed a contract to purchase all four vehicles and promised to bring the remainder of the money when the banks opened. *Id*. at 194. Shirley and three others took the vehicles from the Hudson lot to the Cars of Texas lot, where they left three of the vehicles. *Id*. Shirley used the fourth vehicle to transport the three other drivers and himself back to Henderson. *Id*. Once back in Henderson, the car was involved in an auto accident resulting in the death of another driver, Edelle Newton Irwin. *Id*. The injured parties and her estate filed suit against Hudson, asserting that it still owned the vehicle. *Id*.

[181] *Id*.

[182] *See also In re* Bailey Pontiac, 139 B.R. 629, 633 n.3 (Bankr. N.D. Tex. 1992) (rejecting the need to even consider the application of the Texas CT law given the adoption of § 501.005); Tyler Car & Truck Center v. Empire Fire & Marine Ins. Co., 2 S.W.3d 482, 485 (Tex. App.—Tyler 1999) ("[A]n automobile [sale] which may not be in exact compliance with the [Texas CT law] may still be valid as between the buyer and seller.").

Although, as illustrated by this discussion, Texas has its share of problems with its current CT law, these problems are not unique to Texas; many other states experience similar or greater problems with their CT laws. *See* discussion *infra* Part IV.; *see generally* John Krahmer, *Cars, Boats, and Security Interests: Certificates of Title and the Uniform Commercial Code*, 48 CONSUMER FIN. L.Q. REP. 149 (1994) (discussing the various CT laws in the United States). States use a variety of CT systems, which has led to confusion in and among the states regarding CT laws. *See id*. The existence of these systems flowed from the past promulgation of two uniform CT laws, each of which gained only partial support from the states. *Id*. Even further exacerbating the confusion, every state adopted the UCC, further altering the CT laws in many states and creating a new area for conflict. *See* TEX. BUS. & COM. CODE ANN. § 1, Table of Jurisdictions Wherein UCC Has Been Adopted (West 2011). This piecemeal adoption led to a disconnect between the principles of the UCC, which the states uniformly adopted, and many states' CT laws. *See, e.g.*, Krahmer, *supra*, at 149.

Different authors were one cause of these problems: the early CT laws were drafted by different authors at different times, none of whom followed the UCC. *Id*. Individual state amendments increased the disparities among the states' CT laws and worsened the lack of uniformity, causing confusion for both sophisticated and unsophisticated parties alike. *See id*.

clear scope provisions in UCC Article 9 and an unusual effort by the Texas Legislature to harmonize the conflict via section 501.005. Since this article's first publication in 2009, nothing has changed. The same courts identified in this article have not changed from their interpretation. One additional court, the First Court of Appeals in Houston, has noted that the conflict addressed by the El Paso, Corpus Christi, and Tyler Courts of Appeals exists.[183] Although the court did not find it applicable to the case it was deciding at the time, the First Court of Appeals in Houston acknowledged that the UCC controls in cases where the Texas CT law and UCC lead to different results.[184] The problem lies largely in the fact that the Texas CT law seems largely to have been written in a vacuum, without sufficient regard to other laws with which it must interact, such as the UCC. This is a foundational and pervasive flaw, which can only be fully resolved by comprehensive legal reform. Until that occurs, useless and needless litigation like that noted above will be inevitable.

IV. THE SOLUTION: THE UNIFORM CERTIFICATE OF TITLE ACT[185]

A. Background

These cases clearly indicate that the time has come for enactment of a modern, uniform CT law.[186] Recognizing this, in 2002, amidst continuing case law problems and disparities, and weaknesses in the states' CT laws that present negligent and even devious persons with numerous opportunities to mislead innocent consumers, the NCCUSL formed a Drafting Committee to draft what would become UCOTA.[187] The UCOTA Drafting Committee aimed to address not just the internal disparities, loopholes, and weaknesses that are common in the states' CT laws, but also to address the conflicts within state CT laws, conflicts between these laws and other laws such as the UCC, and inconsistent and erroneous judicial interpretations (often resulting from a poorly-drafted CT law) that pose a risk to innocent buyers and/or secured parties.[188]

NCCUSL created the UCOTA with the intention of responding "to several principal, though by no means exclusive, factors affecting transfers of interests in motor vehicles: diversity of state treatment; the increasing use of electronic records, including efforts to reduce and prevent title and other vehicle fraud, and contracting; evolving commercial practices and current legal issues; and the impact of revised Article 9 of the [UCC]."[189] The UCOTA

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[183] NXCESS Motor Cars, Inc., v. JPMorgan Chase Bank, N.A., 317 S.W.3d 462, 469–70 (Tex. App.—Houston [1st Dist.] 2010, pet. denied).

[184] *Id.*

[185] At this writing, no states have adopted the UCOTA, and Oklahoma is the only state to have introduced it. *See The National Conference of Commissionerson Uniform State Laws*, http://www.uniformlaws.org/ http://www.nccusl.org/Update/uniformact_ factsheets/uniformacts-fs-ucota.asp (last visited Jan. 31, 2008). As noted *supra* note 64 (regarding enactment of the UCC), it is not unusual for the enactment period to be lengthy, no matter how compelling the need. This is clearly a weakness of the state legislative process, and risks a continuing erosion of state law.

[186] *See* Steven N. Leitess, *Lien On Me: Modernizing Certificate of Title Laws: Is it Time for a Uniform Certificate of Title Law?*, 21 AM. BANKR. INST. J. 24, 24 (2003).

[187] *See id*.

[188] *See id*.

[189] *See* UCOTA, *supra*, note 5.

Drafting Committee "determined that a uniform certificate of title law would benefit the business community and purchasers of property affected by such laws, and enhance commerce . . . "[190] The discussion below focuses primarily on how the enactment of UCOTA would resolve the Texas appellate court split, focusing on the sections of UCOTA which protect a good faith purchaser or BIOCOB, but also noting some additional benefits that will accompany the adoption of UCOTA in Texas.[191]

B. Protecting Consumer Expectations

The adoption of UCOTA will bring with it a realistic view of the needs of parties and transactions involving CTs, and for the first time will fully reconcile the Texas CT law with the UCC.[192] In drafting and approving UCOTA, the NCCUSL did not focus on combing through the CT laws of the various states for the details of registering ownership or perfecting security interests, but instead focused on the broad legal issues with the most practicality.[193] Thus, UCOTA does not seek to micromanage the operations of state CT offices, instead merely resolving legal issues that commonly arise in CT transactions.

For example, the vast majority of dealer sales, whether for new or used vehicles, involve a delay between the retail sale and the execution of (or application for) the CT.[194] In recognition of this consumer expectation and common business practice, UCOTA supports the majority of the case law and follows the UCC by allowing a BIOCOB to buy a vehicle from a dealer without first obtaining a CT.[195] This single measure will bring uniformity (based on the majority view and clearly the better view) to an issue that otherwise will generate continuing uncertainty, injustice and needless litigation.

In addition, section 18 of the UCOTA clarifies the customary protection (e.g., as provided in the UCC) for a good faith purchaser.[196] UCOTA section 18(a) recognizes the protections afforded a good faith purchaser for value under UCC section 2-403(1), and UCOTA section 18(b) recognizes the entrustment protections found in UCC section 2-403(2).[197] UCOTA section 19 recognizes UCC section 9-320, an exception to the general rule that a transferee takes ownership subject to prior security interests.[198] This exception, reflected in UCOTA section 19(c), recognizes the right of a buyer of a vehicle covered by a CT, in the ordinary course of business (a BIOCOB) "to take free of claims and security interests created by the

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190 *See* Leitess, *supra* note 186, at 24.

191 *See* Harrell, *supra*, note 7, at 18–19.

192 *See id*. at 9.

193 *See* Leitess, *supra* note 186, at 24.

194 *See* Harrell, *supra* note 7, at 9.

195 *See id.*; *see also* UCOTA §§ 18-19.

196 UCOTA § 18 cmt. 1.

197 *Id*. at § 18 cmts. 1-2. UCC § 2-403(1)-(2) is the equivalent to Texas Business and Commerce Code § 2.403(a)-(b). *See* TEX. BUS. & COM. CODE ANN. § 2.403(a)-(b) (West 2011).

198 UCOTA § 19(c); *see also* UCOTA § 19 cmt. 1. UCC § 9-320 is equivalent to Texas Business and Commerce Code § 9.320. *Compare* U.C.C. § 9-320*, with* TEX. BUS. & COM. CODE ANN. § 9.320 (West 2011). A relationship similar to that of UCC §§ 2.403(2) and 9.320(a) exists between UCOTA §§ 18(b) and 19(c). *See* U.C.C. §§ 2.403(2), 9.320(a); UCOTA § 19 cmt. 1.

seller."[199]

The UCC rules recognized in UCOTA make clear that "the primacy of a [BIOCOB] in merchant sales transactions [is] essential to the smooth functioning of retail markets."[200] This is already the law under the UCC, but, as illustrated by the cases noted in this article, weaknesses in state CT laws have led some courts to misconstrue the laws relating to this fundamental principle. Yet, any other alternative would require real estate sale-like investigations into vehicle ownership and liens prior to making such routine transactions as purchasing or borrowing money on a vehicle.[201]

Because a vehicle's CT is often not held by the dealer, but instead by the dealer's floor-plan lender or a consignor located off-site, a retail buyer (especially a consumer) is likely to be assuaged by the dealer's promises to take care of the CT later and is unlikely to press the issue further.[202] Expecting a buyer to conduct an extensive title examination in making such a routine purchase and not to yield to the promises of the dealer, a person whom the buyer is trusting with the funds needed to make a large purchase, is neither practical nor realistic.[203]

An additional problem would arise even if legislators expected buyers to conduct a title examination like that involved in a real estate transaction.[204] At this time no comprehensive public recording system, like that for real estate titles, exists for personal property ownership and bailments; therefore, no realistic method exists for a buyer to protect against the risks created by CT law provisions like those relied on in *Gallas*.[205] Moreover, in a bailment situation, understanding who is in the best position to prevent the harm helps illustrate why UCOTA sections 18 and 19 are important.[206] As Professor Harrell has noted, "[t]he difficulty of protecting a BIOCOB from claims of a bailor, the relative ease with which a bailor can protect himself [or herself] . . . from the obvious risk of [an unwanted] sale by a merchant bailee, and the need to maintain a smooth-functioning and efficient retail system for sales of goods constitute strong public policy reasons in support of . . . " recognizing the basic rules of the UCC in UCOTA.[207] The UCOTA, again recognizing common expectations and industry practice, specifies in section 19(c) that executing a CT is not required to obtain BIOCOB

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[199] UCOTA § 19 cmt. 5. *See also* U.C.C. § 9-320.

[200] *See* Harrell, *supra* note 7, at 19.

[201] *See id*.

[202] *See id*. at 19 n. 14. In the purchase of a new vehicle, this promise is likely to be even more effective, as the CT normally has not been created at the time of the sale. In addition, as noted, the CT (or other title documentation) may be held by the dealer's secured party, making delivery to the buyer at the time of sale literally impossible.

[203] *Id*. at 19.

[204] Consider, for example, the difficulties faced by the buyers in a case like Vibbert v. Par, Inc., 224 S.W.3d 317 (Tex. App.—El Paso 2006), if required to conduct a pre-purchase title examination. *See supra* notes 152-170 and accompanying text.

[205] *Id. See also* Gallas v. Car Biz, Inc., 914 S.W.2d 592 (Tex. App.—Dallas 1995, writ denied); Harrell, *supra*, note 7, at 9; *supra* text accompanying notes 91-118. It is obviously unrealistic to expect or require a vehicle buyer to understand and resolve such issues before purchasing a vehicle. Given a proper interpretation of the UCC, and a rational CT law, the buyer does not need to do so. Nonetheless, note that UCOTA (by facilitating a comprehensive system of electronic CTs) makes possible the creation of a more useful public record for CT transactions.

[206] *See* Harrell, *supra* note 7, at 9.

[207] *See id*. at 19.

status.[208] The ordinary consumer buying a vehicle from a dealer is thus protected from the claims of a secured party or bailor who entrusted the vehicle to the selling dealer. UCOTA thus recognizes a long-held truism: that those in the best position to avoid the loss should pay the most attention.[209]

C. Other Benefits of UCOTA

Sections 18 and 19 of the UCOTA will resolve the appellate court split in Texas, and those provisions are in good company because many other benefits to Texas CT law will follow from the enactment of UCOTA. For example, "priority rules consistent with the [UCC] . . . will improve efficiency, reduce costs and provide a national body of precedent," while the uniform perfection methodology in UCOTA will reduce uncertainty within the state and choice of law conflicts between states.[210] These changes reflect modern business practices, as conducted all over the United States, and will facilitate both fairness and economic growth, while also providing increased clarity regarding legal outcomes in routine transactions, all of which will also provide for a reduction of costs.[211]

The UCOTA provisions mentioned here are just a few of the provisions that will allow the state to realize such benefits. For example, to facilitate future economic growth, UCOTA permits both written and electronic CTs, but does not require either, and allows for conversions between the two.[212] Also, to facilitate financing transactions, UCOTA is consistent with the most modern perfection methods currently in effect in various states, and reconciles these with UCC Article 9.[213]

An important purpose of "UCOTA is to provide rules that are consistent with other applicable law, such as the UCC, in order to avoid creating costly and troublesome conflicts of law."[214] This is a glaring deficiency in many current CT laws, which too often seem to have been written in a legal vacuum, without regard to related laws. But another goal of UCOTA is to bring the CT law into conformity with common CT office practices and procedures. Today, there are often disparities between what the law says and what the CT office does. Ironically, in some instances, UCOTA is more consistent with CT office practices and procedures than is the current CT law.[215]

Enactment of UCOTA may require small changes in the procedures of some state CT

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[208] *See id*. at 20.

[209] *See id*. at 20 n.16. ("Consumers, particularly unsophisticated ones, do not always respond to public education on such matters and are likely to rely on contrary assurances by the dealer (who wants to sell the car). The prospect of massively changing this fundamental principle of retail transactions in order to save a few bailments gone wrong surely represents a public policy mismatch.").

[210] *See* Leitess, *supra* note 186, at 42.

[211] *See id*.

[212] *See, e.g.*, Edwin E. Smith, *The Effect of the Uniform Certificate of Title Act on Secured Transactions*, 60 CONSUMER FIN. L.Q. REP. 366, 384 (2005).

[213] *Id*. at 383; *see also* Harrell, *supra* note 7, at 6.

[214] *See* Harrell, *supra* note 7, at 8.

[215] *See id*. at 6.

offices, e.g., to facilitate uniformity on such issues as statutory terminology, "title holding" by secured parties, and record-keeping procedures or other similar matters.[216] But such changes will be minimal. The UCOTA's purpose in this regard is to create a uniform CT law, based on current practices, that the states can apply without difficulty; thus, most states will have to make few changes, and will find that the bulk of the UCOTA is consistent with current state laws, practices, and procedures.[217]

V. A TUNE-UP FOR TEXAS CT LEGISLATION

A. Need for a Broad Perspective

Uniform laws have proven themselves indispensible to modern commerce.[218] Given the national or regional scale on which many companies now do business, simpler and uniform interstate transactions law poses a significant opportunity to reduce costs and confusion, and to improve business conditions for the industry and consumers alike.[219] If the lessons learned from the history of uniform laws, including the nation-wide adoption of the 1999 revisions to UCC Article 9, are any indication, creditors, dealers, and borrowers alike will reap many benefits from the enactment of UCOTA.[220]

Laws, particularly those designed to apply to millions of people and ordinary transactions in inevitably varying situations, are rarely perfect.[221] However, the hope for a better law is not unrealistic, and is a stated goal of legislative sessions.[222] Roy L. Steinheimer, Jr., former Dean of Washington and Lee University School of Law, has noted that, when grouped together and considered as a whole, separately from the remaining corpus of the legislation, the flaws in an existing law may seem formidable.[223] However, when considered in the context of the entire statute, the provisions of which resolve disputed matters or produce desirable outcomes, the admirable overall aspects of the law, as found in most provisions, and the seeming insignificance of most of the flaws-the shortcomings may shrink to a size which seem unlikely to significantly impair the statute's usefulness.[224] This makes reform of such a law, such as the Texas CT law, a formidable challenge, despite its obvious flaws. The flaws in such statutes have been described by Judge Brewster as "spots on the sun. It takes an expert to see them, and he must use glasses at that."[225] Nonetheless, the defects, as Dean Ames said, "must inevitably be followed, sooner or later, by additional legislation to remedy the evils which

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216 Smith, *supra* note 212, at 387–88.

217 *See* Harrell, *supra* note 7, at 6–9.

218 *See* Leitess, *supra* note 186, at 42.

219 *See id*.

220 *See id*.

221 *See* Roy L. Steinheimer, Jr., *The Uniform Commercial Code Comes of Age*, 65 MICH. L. REV. 1275, 1278–79 (1967).

222 *See id*. at 1278–80.

223 *Id*. at 1279 (quoting Charles L. McKeehan, *The Negotiable Instruments Law (A Review of the Ames-Brewster Controversy*), 50 U. PA. L. REV. 437, 589–90 (1902)).

224 *Id*.

225 *Id* at 1278 (quoting Lyman D. Brewster, *A Defense of the Negotiable Instruments Law*, 10 YALE L.J. 84, 97 (1901)). At the time Judge Brewster's article was published, he was serving as the President of the NCCUSL.

they . . . introduce."[226] In the context of CT laws and transactions, such evils are increasingly apparent, and the curative legislation is UCOTA.

B. The Alternatives are Inadequate

By looking at other possibilities for addressing conflicts between a CT law and the UCC, and thereby understanding why those other possible solutions will not work, the necessity for the UCOTA becomes even more apparent. No other solution will solve the problems on a uniform, national basis consistent with our fundamental system of state law. The Texas Supreme Court could address each conflict and clarify the applicable law, but has refused to accept the few cases which were appealed from the appellate courts to clarify the proper law to be applied.[227] Moreover, such a solution would be inherently piecemeal and interstitial, addressing isolated issues in narrow fashion without the benefit of an overarching perspective; this approach is likely to introduce new problems even as it solves old ones. While this illustrates the value of common law methodology as a solution to legislative failure, it also illustrates the immense value of the uniform law alternative.

Another possible solution could consist of a public awareness campaign, including mass notifications distributed throughout multiple forums and media, from newspapers and television to the internet, seeking to inform consumers as to the intricacies of CT law so they can suitably protect themselves in the current legal environment.[228] Another, similar option is to use a medical-like informed consent document given to the consumer prior to the purchase of any automobile.[229] These types of solutions present multiple problems, beyond the obvious probability that the information will not reach potential victims or that they might not understand it. Many consumers do not read directions, contracts, or warnings, and they are highly unlikely to change that behavior in such a common transaction.

Beyond the substantial cost, another problem is that such methods would require dealers and creditors to change their business practices, e.g., if the consumer education campaign succeeded in warning the buyer that he or she must leave the dealership with an executed CT to ensure protection of ownership rights. In many instances this simply is not possible, e.g., because the vehicle is new and no CT has been created yet or because the CT is being held by a consignor or the dealer's inventory lender. If the state pursued this alternative, people would no longer be able to buy a car and drive it off the lot that day; to protect against losing the vehicle to a secured party, consignor, or other claimant, the BIOCOB would have to come back to pick up the vehicle and pay for it after the CT was executed and transferred. And, suppose the buyer traded in a vehicle, should he or she go without a car until the CT arrives? As a practical matter, a vehicle sale in which the transfers of possession are deferred will likely

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[226] Steinheimer, *supra* note 221, at 1278 (quoting James Barr Ames, *The Negotiable Instruments Law. A Word More*, 14 HARV. L. REV. 442, 449 (1901)). James Barr Ames was Dean of the Harvard Law School at the time Dean Steinheimer published this article.

[227] *See* First Nat'l Bank of El Campo, TX v. Buss, 143 S.W.3d 915 (Tex. App.—Corpus Christi 2004, pet. denied); Hudson Buick, Pontiac, GMC Truck Co. v. Gooch, 7 S.W.3d 191 (Tex. App.—Tyler 1999, pet. denied); Gallas v. Car Biz, Inc., 914 S.W.2d 592 (Tex. App.—Dallas 1995, writ ref'd).

[228] This is an obviously inadequate solution. *See, e.g.*, *supra* notes 203, 207.

[229] *See* Harrell, *supra* note 189, at 20 n.16.

turn out to be no sale at all, with adverse consequences for all concerned. Thus, these alternatives to UCOTA come with a host of new problems, both legal and practical, and stray far from the legislature's apparent intent, an intent that will be furthered by enactment of UCOTA.

C. Properly Allocating the Risks

As noted, UCOTA properly places the consequences of an ownership transfer gone wrong on the party best able to avoid the loss.[230] Often, the dealer is responsible—because of a failure to file or submit the required documents correctly, a financial failure, or both—for the failure to obtain a proper transfer of the CT.[231] The inventory lender's failure to monitor its debtor may be another factor, but the lender's ability to trace and claim the proceeds of the sale (under UCC section 9-315) may mitigate this loss. Because the dealer's inventory lender made an evaluation of the dealership's financial health before agreeing to fund the dealership, and is also in the best position to continually monitor the business and financial practices of the dealership, these consequences should lie with that lender.[232] The consignor is similarly responsible for gauging the financial stability of a dealer to whom the consignor entrusts the vehicle.

From the standpoint of balancing the risks and rewards, the dealer's inventory lender or consignor should accept the consequences when the dealership it financed (or entrusted the vehicle to) fails. The dealer's inventory lender or consignor is the party benefitting from its relationship with the dealer and has both the duty and a superior ability to continually evaluate the risk.[233] The inventory lender or consignor profits from its relationship with the dealer and entered the relationship with its eyes open; by providing the resources to maintain the dealer in business, the inventory lender or consignor permits the dealer to make sales to the public. The lender or consignor can be expected to assess the dealer's financial position,[234] whereas the retail buyer often goes to the dealer based largely on word of mouth, or based on prior purchasing experience with the dealer, advertising, or convenience, or because a particular vehicle is sitting on the dealer's lot. The buyer has no practical means to gauge the solvency or vehicle ownership status of the dealer. The buyer rarely, if ever, enters into a car-buying relationship with a dealer having the same knowledge of the dealer's ownership and financial status as does the inventory lender or consignor.[235]

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[230] *See* discussion *supra* Part IV. Of course, not in every situation should the burden rest with the dealer's secured party, but when the buyer is not responsible for the failure to transfer the CT that burden obviously should not be imposed on him or her.

[231] *See* cases cited *supra* note 11.

[232] *See, e.g.*, Comptroller of the Currency Administration of National Banks. Floor Plan Loans: Comptroller's Handbook, at *1. http://www.occ.treas.gov/handbook/floorplan1.pdf (last visited Feb. 29, 2008) [hereinafter Comptroller].

[233] *See* 8 OXFORD ENGLISH DICTIONARY, 822 (1989) (A lender is "one who makes a business of lending money at interest."); *see also supra* note 230 and accompanying text.

[234] *See* Comptroller, *supra* note 232, at *5–7 (example of the procedure a lender goes through before determining whether or not to become the lender for that dealership).

[235] *See* Alvin C. Harrell, *Can a Buyer and Secured Party Rely on a Certificate of Title? Part II*, 76 OKLA. B.J. 447, 450 (2005).

Given reasonable due diligence, the inventory lender or consignor may be able to protect itself against these problems.[236] With the inventory lender's knowledge of the dealership's practices and the industry as a whole, its inherent incentive for minimizing risk, and the ability to trace proceeds and require a collateral "cushion," the inventory lender stands a greater chance of effecting decisions by the dealership.[237] The consignor is in much the same position. An average Joe may be able to impact the customer service aspect through customer complaints, but stands little chance of altering the inventory ownership and financial position of the dealership.[238]

The inventory lender's knowledge of the dealership, its ability to limit and diversify its risk, and its financial leverage make the risk of loss more appropriately placed with the inventory lender than the buyer.[239] Again, the consignor is in a similar position to the secured party. Adoption of the UCOTA will assure that this risk is placed in the hands of the proper party.[240]

D. Eliminating Conflicts

In addition, by the enactment of UCOTA, the legislature can insure that any residual or future conflicts between the CT law and the UCC will disappear. UCOTA follows closely the ultimate goals of the UCC, and since the Texas Legislature adopted the UCC almost unchanged, it stands to reason that the legislature should support adoption of the UCOTA.[241] But as noted, in Texas, beyond this general benefit, there is a specific benefit to follow from the adoption of UCOTA: the resolution of a nonsensical and confusing conflict between these important state statutes, and the resolution of divergent lines of cases.[242]

Adoption of UCOTA will remedy this split, and clarify the law so as to conform to the common and reasonable expectations of consumers, dealers, and creditors, protecting legitimate expectations in these commercial contexts. But UCOTA also provides a number of other benefits, such as a legal structure to accommodate electronic titling, and consistency with other laws governing electronic transactions.[243] One of the purposes of law in general, and of the UCC specifically, is to allow people to easily and accurately predict the outcome of a

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[236] *See* Comptroller, *supra* note 232, at *20–21 (example of the procedure a lender undertakes before recommending corrective actions for noted deficiencies).

[237] *See* Comptroller, *supra* note 232, at *1–2 (listing warning signs that may warrant a reconsideration of the credit arrangement). The lender, given this relationship with the dealership, may be in a position to help the dealer get back on its feet by arranging additional loans, or restructuring the current agreement.

[238] Dealer bankruptcy is also a significant risk. The lender and consigner have the ability to protect themselves by asserting secured claims, the buyer does not. *See, e.g.*, 11 U.S.C. § 506.

[239] *See generally* Comptroller, *supra* note 232 (containing an introduction to the lending relationship and a detailed description of the procedures).

[240] *See supra* notes 231–37 and accompanying text.

[241] *See supra* notes 216–30 and accompanying text; *see also* discussion *supra* Part IV.

[242] *See* discussion *supra* Parts III–IV.

[243] *See also* Harrell, *supra* note 7 for a broader discussion of the UCOTA's general benefits. See also Harrell, *supra* note 165, for another specific example. The other benefits that UCOTA would bring to Texas are extensive but a further discussion of these other benefits is beyond the scope of this article.

particular course of action.[244] This principle is essential in a business or commercial law context, where the willingness of consumers and commercial entities to spend significant amounts of money depends on their ability to predict the outcome of a transaction and to insulate themselves from unforeseen losses. The American economy is resilient, and can easily adapt to a new law, if it is not too onerous; however, it is not a fortune-teller—predictable legal results are a fundamental necessity for the conduct of business and consumer transactions. Today, and absent enactment of UCOTA, many dangerous uncertainties lurk beneath the surface of our CT laws.

E. Stalled Legislative Movement

As of March 2013, no state has adopted UCOTA. Oklahoma has been the only state to consider legislation to adopt UCOTA. Oklahoma considered such legislation in 2007, 2008, 2009, 2010, and is set to do the same in 2013.[245] Although, Oklahoma remains the only state where legislation has been proposed, several states have studied the benefits that UCOTA could provide to the states' CT and related processes.[246] Some criticism of UCOTA has come from the American Association of Motor Vehicle Administrators ("AAMVA"). While the AAMVA believes that UCOTA provides a useful framework for electronic titling procedures, the AAMVA has expressed some concerns over the language of the proposed law, but cites the two primary concerns: (1) lack of available funds for states to implement the UCOTA-dictated changes; and (2) higher priority issues facing state motor vehicle administrators.[247] The AAMVA's two concerns are intertwined because, in the AAMVA's view, the cost for UCOTA implementation will be significant in most states while most states will face multiple demands for not just funding, but also staff, information technology resources, and time.[248] This reality is even more prominent as states face implementing federally-mandated programs, such as the Real ID Act, that likely take priority over optional changes like UCOTA.[249] As issues regarding conflicts between state CT laws and the UCC, and conflicts between the various CT laws of the states continue to create problems that demand a solution, interest in implementation will hopefully outweigh the obstacles to its enactment.

VI. CONCLUSION

Adoption of UCOTA will serve the best interests of the state and its citizenry, including

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[244] *See* 10 HAWKLAND U.C.C. SERIES § 10-101:01 (2007) (recognizing fairness as a legal principle in Anglo-American law).

[245] *See* Barry A. Graynor, Teresa Davidson, Edwin Huddleson, III, and Stephan T. Whelan, *Survey—Uniform Commercial Code: Uniform Commercial Code Survey: Leases*, 63 BUS. LAW. 1301, 1301 n.1 (2008); *see also* UNIFORM LAW COMMISSION, (last visited February 25, 2013) http://www.uniformlaws.org/Legislation.aspx (search "Certificate of Title Act" in "Act Title or Keywords" and select "Last 10 Years" in "Bill Date").

[246] *See, e.g.*, CTC & Assocs. LLC, *Vehicle Titling Issues Peer Exchange: UCOTA and Other Approaches* (Oct. 16-17, 2007), http://ntl.bts.gov/lib/34000/34700/34794/Vehicle_Titling_Issues_PE_-_Final_Report.pdf.

[247] *See id.* at apps. B1, B2. *But see id*. at app. B3 (NCCUSL's Response to AAMVA Regarding UCOTA).

[248] *Id.* at app. B1.

[249] *Id*. To illustrate the challenges, it's worth noting that Real ID Act implementation has been delayed in several states and the federal government has granted extensions to states that have not met the standards. *See* NATIONAL CONFERENCE OF STATE LEGISLATURES, *Count Down to REAL ID*, (December 21, 2012) http://www.ncsl.org/issues-research/transport/count-down-to-real-id.aspx.

the CT office, the business community, and consumers. UCOTA clarifies the law and places the burden in priority conflicts with the proper party, e.g., the dealer's secured party, but also reinforces the reasonable expectations of the secured party or consignor, allowing lenders and consignors to conduct their transactions more efficiently. Other options available to address these issues not only do not solve the problems, but would create additional, unnecessary problems; moreover, the UCOTA fixes the Texas appellate court split and provides other benefits which will serve the interests of the state and its citizens for many years to come. With the domestic auto industry increasingly focused on the federal government, and its dealer systems in disarray,[250] these traditional sources of support for state commercial law reform may be missing in action. It is time for the states to step up, and recognize the need for this reform and their own interest in creating a clear and uniform system of state CT laws.

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[250] *See, e.g.*, Mike Spector & Josh Mitchell, *U.S. Turns Focus to Health of Auto Suppliers*, WALL ST. J., July 14, 2009, at B1 (noting the increased role of the federal government in auto industry matters); Associated Press, *Chrysler's lineup sees dip in sales,* OKLAHOMAN, July 3, 2009, at B3; Associated Press, *GM, Chrysler executives defend decision to close dealerships,* OKLAHOMAN, June 13, 2009, at B3.

LIFTING THE VEIL AND FINDING THE POT OF GOLD:

PIERCING THE CORPORATE VEIL AND SUBSTANTIVE CONSOLIDATION IN THE UNITED STATES

Judith Elkin*

You are sitting at your desk eating lunch when the phone rings. It is a friend of yours who is a corporate partner at another law firm. She has been representing a large real estate developer for years. Her main client contact has always been the flamboyant majority owner of the enterprise, Joe Castle. His empire is crumbling. The real estate market has softened significantly, and his bondholder creditors have just discovered that there is significantly more debt owed than had allegedly been disclosed to them. She wants your help in defending against potential litigation.

Over time, the enterprise has been structured such that there is a public holding company, Castle Development, Inc. ("CDI"), with several separate subsidiaries set up for specific development projects. Mr. Castle is chairman of the board and chief executive officer of CDI, and a majority of CDI's stock is owned by Mr. Castle and his family members. A related privately held company, Golden Land, Inc., is also owned by Mr. Castle and his family. Golden Land also is in the real estate development business and has several operating subsidiaries, some of which operate separate development projects, and some of which provide services and amenities, like golf courses, to CDI projects.

In order to facilitate operations, a centralized cash management account has been established at Senior Bank, the bank which is also the agent on CDI and Golden Land's senior secured credit facility. CDI and Golden Land are co-borrowers under the credit facility, which is guaranteed by certain of the public company subsidiaries and certain of the private company subsidiaries. Senior Bank has a lien on the stock of all these entities. Various other lenders have liens on the real estate owned by subsidiaries. In addition, both CDI and certain of its operating subsidiaries have separately issued unsecured public bond debt.

Mr. Castle and his family members sit on the board of each entity, and while there are a few outside directors at CDI, they are, for the most part, friends of the family. Mr. Castle and his family have always enjoyed the finer things in life. They have acquired some vineyards in France and a small independent movie production company, which is run by one of Mr. Castle's granddaughters. Mr. Castle's son, Joe Jr., is the chief financial officer ("CFO") of both CDI and Golden Land, and has had unfettered control of the books and records, as well as

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of the cash management account. All cash received by any operating subsidiary is swept daily into the cash management account, and that account has been used for the operations of both the publicly and privately held companies. Joe Jr. must approve every financial transaction, every intercompany payable and receivable, and every ledger entry. It is also clear that some of Mr. Castle and his family's personal projects have also been funded through the centralized cash management system used by both the public and private companies.

The public bondholders of CDI and the public bondholders of certain operating subsidiaries allege they have just learned that the entities that owe them money are also liable for certain other significant debts incurred by CDI and Golden Land and its subsidiaries, allegedly making their obligors insolvent. The bondholders are threatening litigation or bankruptcy, or both, against CDI and its subsidiaries, and are seeking to bring into the pot all the assets and subsidiaries of Golden Land, claiming that the entities really are one single enterprise and that all the assets of the consolidated entities should be available to pay their claims. Will the bondholders be successful?

I. PIERCING THE CORPORATE VEIL

A. Generally

In general, corporations are treated as legal persons, and each corporate entity, regardless of whether it is a parent, subsidiary, or affiliate is viewed as having separate assets and liabilities, distinct from those of its shareholders and related entities.[1] The concept of limited liability for corporate shareholders has been an underpinning of U.S. corporate law for over a century, and is contained in most state corporate law statutes.[2] In most circumstances, a creditor who does business with Corporation A will not be able to seek payment from Corporation A's parent corporation or shareholder. A creditor "is presumed to have voluntarily and knowingly entered into an agreement with a corporate entity and is expected to suffer the consequences of the limited liability associated with the business form."[3]

Veil-piercing is an equitable doctrine through which a court holds a shareholder liable for the obligations of its corporation. A related theory, alter ego, enables a court to treat separate corporations as one legal entity, hold each liable for the debts of the other, and consolidate the assets of both. As a technical matter, alter ego is one part of the test for veil-piercing, though courts sometimes use them interchangeably and sometimes refer to them as separate theories. These theories, through which a court may disregard the separateness of the corporate entity, are attractive remedies for creditors of insolvent entities, and a significant amount of litigation is generated by attempts to seek such relief. The actual standards for piercing the corporate veil and alter ego have been developed over time by state case and sometimes, statutory, law, as applicable to the jurisdictions of the corporations involved in the dispute.[4] While the standards

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[1] Alexander & Alexander of N.Y. Inc. v. Fritzen, 495 N.Y.S.2d 386, 388 (N.Y. App. Div. 1985); *see also* Meshel v. Resorts Int'l of N.Y., Inc., 553 N.Y.S.2d 342, 342 (N.Y. App. Div. 1990).

[2] KAREN VANDEKERCKHOVE, PIERCING THE CORPORATE VEIL, § 1.1.2, at 4 (2007).

[3] I. WILLIAM MEAD FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF CORPORATIONS § 41.85 (perm. ed., rev. vol. 1999).

[4] For purposes of this article, most references are to veil-piercing case law from the states of New York and

and application may differ slightly from state to state, a list of criteria has developed which most courts use to analyze a given fact pattern.

B. The Factors

The factors courts look at in varying degrees include:

- A disregard of corporate formalities, such as not keeping separate books and records or holding separate board of director meetings;
- Overlapping ownership, officers, and directors;
- Inadequate capitalization;
- Lack of separate employees;
- Intermingling or comingling of funds;
- Shared bank accounts;
- Shared office space;
- Consolidated financial statements;
- The degree of discretion a subsidiary has over its operations or its assets;
- Whether dealings between the entities were conducted at arm's length;
- Whether the corporations are treated as independent profit centers;
- Have the subsidiary entities been required to guarantee the dominant corporation's debts or pledge their assets to secure the dominant corporation's debts;
- Has the subsidiary paid the debts of the parent in the past;
- Are the assets or operations of the entities separate or intermingled;
- Has the corporate fiction been used to perpetrate a fraud;
- Are the corporations operated or organized such that one is a mere conduit of the other;

Delaware, as these are primary jurisdictions for corporate law analyses.

- Has the corporate fiction been used to avoid or evade an existing legal obligation;
- Has the corporate fiction been used to create a monopoly; and
- Has the corporate fiction been used to circumvent a statute (either civil or criminal).[5]

In assessing these factors, courts look at the totality of the circumstances, and no one factor will be determinative.[6]

The court will disregard the corporate form only in "exceptional case[s]."[7] Several states have now emphasized the fraud element, especially in contract cases where the plaintiff entered into the agreement voluntarily and presumably did due diligence on the entity with which it was doing business.[8] A decision to pierce the veil requires consideration of any fraudulent action committed under the guise of the corporate form.[9]

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[5] *See, e.g.*, Winner Acceptance Corp. v. Return on Capital Corp., No. 3088–VCP, 2008 WL 5352063, at *5 (Del. Ch. Dec. 23, 2008) (listing several factors and emphasizing the necessity for finding the element of fraud); Phoenix Cos. v. Abrahamsen, No. 05 Civ. 4894, 2005 U.S. Dist. LEXIS 43615, at *17–18 (S.D.N.Y. Sept. 28, 2006) (citing MAG Portfolio Consultant, GMBH v. Merlin Biomed Grp., LLC, 268 F.3d 58, 63 (2d Cir. 2001)); Castleberry v. Branscum, 721 S.W.2d 270, 272 (Tex. 1986) (listing numerous factors); *see also* AHA Sales, Inc. v. Creative Bath Prods., Inc., 867 N.Y.S.2d 169, 183 (N.Y. App. Div. 2008) (same); Associated Vendors, Inc. v. Oakland Meat Co., 26 Cal. Rptr. 806, 813–15 (Cal. App. 1962) (listing 20 factors).

[6] *See, e.g.*, Carte Blanche (Sing.) Pte., Ltd. v. Diners Club Int'l, Inc., 2 F.3d 24 (2d Cir. 1993) (piercing the corporate veil where the parent and subsidiary failed to observe corporate formalities, the subsidiary did not keep corporate records, had no assets, had no separate offices or letterhead, had no paid employees or board of directors, all revenues were put directly into the parent's bank account, had no separate personnel or payroll, and revenues and marketing reports were not recorded independently); Wm. Passalacqua Builders, Inc. v. Resnick Developers S., Inc., 933 F.2d 131, 140 (2d Cir. 1991) (piercing corporate veil where parent and subsidiary shared office space and officers, intermingled funds, and were not treated as separate profit centers). For cases where some factors were present but deemed insufficient to pierce the corporate veil because others were not present, see, for example, Time Square Constr., Inc. v. Mason Tenders Dist. Council, No. 07 Civ. 7250, 2008 U.S. Dist. LEXIS 206, at *13 (S.D.N.Y. Jan. 2, 2008) (declining to pierce the corporate veil where the subsidiary had a formal corporate existence, sufficient capitalization, its own office space, freedom to act independent of the parent, no intermingling of property and employees left the parent company when they went to work for the subsidiary); *Phoenix Cos.,* No. 05 Civ. 4894, 2005 U.S. Dist. LEXIS 43615, at *18–19 (declining to pierce the corporate veil where there was no evidence of a disregard of corporate formalities or any evidence that the subsidiary's commercial interests were subordinated to those of the parent, the parent and subsidiary maintained separate officers, had different business models, did not commingle property or funds, and employees received separate payments from the parent and subsidiary under their respective contracts with those entities); Stiftung v. V.E.B. Carl Zeiss, Jena, 298 F. Supp. 1309, 1317–18 (S.D.N.Y. 1969), *modified*, 433 F.2d 686 (2d Cir. 1970) (declining to pierce the corporate veil where employees were hired and paid only by the subsidiary and not the parent; the subsidiary and parent kept their records separate, prepared their own financials, paid their own operating expenses, and maintained their own health insurance plans and bank accounts).

[7] Sprint Nextel Corp. v. iPCS, Inc., No. 3746-VCP, 2008 WL 2737409, at *11 (Del. Ch. July 14, 2008) (quoting Sears, Roebuck & Co. v. Sears plc, 744 F.Supp. 1297, 1305 (D. Del. 1990).

[8] *See, e.g.*, Mancorp Inc. v. Culpepper Props., Inc., 836 S.W.2d 844, 847–48 (Tex. App.—Houston [1st Dist.] 1992, no writ).

[9] Midland Interiors, Inc. v. Burleigh, No. 18544, 2006 Del. Ch. LEXIS 220, at *7–11 (Del. Ch. Dec. 19, 2006)

Courts will pierce the corporate veil and hold two corporations to constitute a single legal entity where "complete domination was exercised over a corporation with respect to the transaction attacked, and that such domination was used to commit a fraud or wrong against the plaintiff which resulted in plaintiff's injury."[10] "Additionally, 'the corporate veil will be pierced to achieve equity, even absent fraud, [w]hen a corporation has been so dominated by an individual or another corporation and its separate entity so ignored that it primarily transacts the dominator's business instead of its own and can be called the other's alter ego.'"[11]

In sum, veil-piercing in the United States is a fact specific, holistic inquiry based on the factors addressed above. Because the ultimate determination on veil-piercing is based on the totality of the circumstances,[12] it is difficult to predict how a court will assess any particular relevant factor on its own. Thus, in order to best avoid veil-piercing, a company should, at the minimum, maintain corporate formalities, sufficiently capitalize the subsidiary, and treat the parent and subsidiary companies as independent profit centers. In addition, corporations and their shareholders should pay heed to as many of the additional factors as possible: maintain separate funds and property for the parent and the subsidiary companies; keep overlap in ownership, officers, directors and personnel to a minimum; maintain distinct office space for each corporate entity; and keep all dealings between the parent and subsidiary at arms-length. In analyzing the situation of poor Mr. Castle and his empire, many of these precautions were overlooked and ignored. However, whether the facts can give rise to a finding of actual fraud against the bondholders is unclear, and in a jurisdiction where the fraud finding is paramount, Mr. Castle may still be protected from attempts by the companies' bondholders to pierce the corporate veil.

(piercing allowed where corporate formalities ignored, company was insolvent, and individual shareholder had not only committed fraud when he negotiated contract with plaintiff knowing corporation had become inactive but then again on the small claims court in the original lawsuit when he consented to entry of a judgment he knew the corporation could not pay); *see also* Harper v. Del. Valley Broadcasters, Inc., 743 F.Supp. 1076, 1085 (D. Del. 1990), *aff'd*, 932 F.2d 959 (3d Cir. 1991).

[10] Williams v. Lovell Safety Mgmt. Co., 896 N.Y.S.2d 150, 151 ('N.Y. App. Div. 2010) (citing Matter of Morris v. N.Y. State Dep't of Taxation & Fin., 82 N.Y.2d 135, 141 (1993) (internal quotations omitted); *see also Castleberry,* 721 S.W.2d at 272.

[11] *Williams*, 896 N.Y.S.2d at 151 (quoting Matter of Island Seafood Co. v. Golub Corp., 759 N.Y.S.2d 768, 769 (N.Y. App. Div. 2003); *see also* Pebble Cove Homeowners' Ass'n v. Fid. N.Y. FSB, 545 N.Y.S.2d 362, 363 ('N.Y. App. Div. 1989); Trs. of Vill. of Arden v. Unity Constr. Co., No. 15025, 2000 WL 130627 (Del. Ch. Jan. 26, 2000) ("A court can pierce the corporate veil of an entity where there is fraud or where a subsidiary is in fact a mere instrumentality or alter ego of its owner."); Mabon, Nugent & Co. v. Tex. Am. Energy Corp., No. 8578, 1990 WL 44267, at *838 (Del. Ch. Apr. 12, 1990) ("[C]orporate veil may be pierced where there is fraud . . .[but] the Delaware courts have also stated. . .the corporate veil may be pierced where a subsidiary is in fact a mere instrumentality or alter ego of its parent. . .[and] where equitable considerations require it."); Humana, Inc. v. Kissun, 471 S.E.2d 514, 515 (Ga. Ct. App. 1996), *rev'd*, 479 S.E.2d 751 (Ga. 1997) (to pierce corporate veil it must be shown that parent's disregard of corporate entity made subsidiary mere instrumentality for transaction of parent's affairs, that there was such unity of interest in ownership that separate personalities of subsidiary and parent no longer exist, and that to adhere to doctrine of corporate entity would promote injustice or protect fraud).

[12] Wm. Passalacqua Builders, Inc. v. Resnick Developers S., Inc., 933 F.2d 131, 140 (2d Cir. 1991).

II. SUBSTANTIVE CONSOLIDATION

A. Generally

Substantive consolidation is an equitable doctrine that permits a bankruptcy court, in appropriate circumstances, to disregard the legal separateness of a debtor and a related but distinct legal entity, which may or may not itself be a debtor in bankruptcy, and to merge their respective assets and liabilities for bankruptcy purposes. Substantive consolidation typically results in the pooling of liabilities and assets of the entities being consolidated, the satisfaction of liabilities from the resultant common fund of assets, and the elimination of all duplicate and inter-entity claims.[13] Because substantive consolidation is an equitable remedy, however, the exact consequences of substantive consolidation vary from case to case.[14]

Because the entities being consolidated frequently will have different debt-to-asset ratios, substantive consolidation invariably redistributes wealth among the entities' respective creditors.[15] Thus, as courts have emphasized repeatedly, consolidation vitally affects parties' substantive rights and should be used sparingly after careful scrutiny of the evidence.[16] Some court decisions, however, have noted a "modern" or "liberal" trend toward allowing substantive consolidation.[17] The Third Circuit in *In re Owens Corning* rejected this trend.[18]

Substantive consolidation is analogous to the non-bankruptcy law remedy of piercing the corporate veil. In fact, courts hearing early substantive consolidation cases applied a test for substantive consolidation that was virtually identical to the test used for piercing the corporate veil.[19] Substantive consolidation was accomplished in early cases by finding that the entity with which consolidation was sought was the "alter ego" or an "instrumentality" of the debtor, which was used by the debtor to hinder, delay, or otherwise defraud creditors.[20]

Although courts in early substantive consolidation cases looked to state corporate veil-piercing law for guidance, modern courts have increasingly looked to a growing body of

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[13] *In re* Augie/Restivo Baking Co., 860 F.2d 515, 518 (2d Cir. 1988) (citing 5 L. King, COLLIER ON BANKRUPTCY ¶ 1100.06, at 1100–32, n.1 (15th ed. 1988)); *In re* Ltd. Gaming of Am., Inc., 228 B.R. 275, 286 (Bankr. N.D. Okla. 1998); *In re* Standard Brands Paint Co., 154 B.R. 563, 569 (Bankr. C.D. Cal. 1993).

[14] *See In re* Deltacorp, Inc., 179 B.R. 773, 777 (Bankr. S.D.N.Y. 1995) (noting that the court is afforded a great deal of discretion in constructing a consolidation order and retains the power to order less than complete consolidation); *see also* 2 Alan N. Resnick & Henry J. Sommers, COLLIER ON BANKRUPTCY ¶ 105.09[2] (16th ed., 2011) (stating that substantive consolidation cases are fact specific and must be decided on a case-by-case basis).

[15] *See* Eastgroup Props. v. S. Motel Ass'n, 935 F.2d 245, 248 (11th Cir. 1991) (quoting *In re* Auto-Train Corp., 810 F.2d 270, 276 (D.C. Cir. 1987)); *In re Ltd. Gaming*, 228 B.R. at 286–87.

[16] *See* Fed. Deposit Ins. Corp. v. Colonial Realty Co., 966 F.2d 57, 61 (2d Cir. 1992) (quoting Chem. Bank N.Y. Trust Co. v. Kheel, 369 F.2d 845, 847 (2d Cir. 1966)); *In re Ltd. Gaming*, 228 B.R. at 287.

[17] *E.g.*, *Eastgroup Props.*, 935 F.2d at 248–49, n.10 (citing cases); *In re* Walnut Equip. Leasing Co., No. 97-19699DWS, 1999 WL 288651, at *3 n.9 (Bankr. E.D. Pa. May 4, 1999); *In re* Bonham, 226 B.R. 56, 83 (Bankr. D. Alaska 1998), *aff'd*, 229 F.3d 750 (9th Cir. 2000).

[18] *In re* Owens Corning, 419 F.3d 195, 209 n.15 (3d Cir. 2005).

[19] *See In re* Standard Brands Paint Co., 154 B.R. 563, 567 (Bankr. C.D. Cal. 1993) (citing cases).

[20] *E.g.*, Maule Indus., Inc. v. Gerstel, 232 F.2d 294, 297 (5th Cir. 1956) (citing Fish v. East, 114 F.2d 177, 191 (10th Cir. 1940)).

federal common law opinions decided under federal bankruptcy law.[21] Consequently, federal courts rely almost uniformly on the federal common law instead of on state corporate law in deciding whether or not to substantively consolidate.

Substantive consolidation is an equitable remedy. Its sole purpose is to ensure the equitable treatment of all creditors, not just a particular plaintiff.[22] As a result, substantive consolidation does not require a finding of fraud or intent to hinder or delay creditors, but merely a finding that consolidation would be more equitable to all parties under the circumstances.[23] While later cases have relaxed the requirement of fraud in favor of other factors warranting substantive consolidation, courts will still pierce the corporate veil to effect a substantive consolidation if fraud or similar activity is present.[24] In addition, courts may disregard an entity when it is not operated independently of another entity.[25] In sum, however, substantive consolidation is different from piercing the corporate veil.[26]

While the issue of substantive consolidation typically arises in the context of an affiliated group of corporations, one or more of which is in bankruptcy, the doctrine is equally applicable to cases involving non-corporate entities, such as partnerships and their individual partners.[27]

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[21] *See Eastgroup Props.*, 935 F.2d at 248–49; *In re* Augie/Restivo Baking Co., 860 F.2d 515, 518–19 (2d Cir. 1988); *In re* Auto-Train Corp., 810 F.2d 270, 276 (D.C. Cir. 1987); *In re* Cont'l Vending Mach. Corp., 517 F.2d 997, 1000–01 (2d Cir. 1975); *In re* Flora Mir Candy Corp., 432 F.2d 1060, 1062 (2d Cir. 1970); Chem. Bank N.Y. Trust Co. v. Kheel, 369 F.2d 845, 847 (2d Cir. 1966); Soviero v. Franklin Nat'l Bank, 328 F.2d 446, 448 (2d Cir. 1964); *In re* Tip Top Tailors, Inc., 127 F.2d 284, 288–89 (4th Cir. 1942). *But see In re* Alico Mining, Inc., 278 B.R. 586, 588–89 (Bankr. M.D. Fla. 2002) (basing substantive consolidation on alter ego theory); *In re* Moran Pipe & Supply Co., 130 B.R. 588, 591–92 (Bankr. E.D. Okla. 1991) (same).

[22] Fed. Deposit Ins. Corp. v. Colonial Realty Co., 966 F.2d 57, 61 (2d Cir. 1992); *In re Augie/Restivo Baking Co.*, 860 F.2d at 518; *In re* Cooper, 147 B.R. 678, 683–84 (Bankr. D.N.J. 1992).

[23] *In re* Munford, Inc., 115 B.R. 390, 394 (Bankr. N.D. Ga. 1990); *see In re* Tureaud, 45 B.R. 658, 661–62 (Bankr. N.D. Okla. 1985), *aff'd*, 59 B.R. 973 (N.D. Okla. 1986).

[24] *See In re* Daily, 107 B.R. 996, 1007 (D. Haw. 1989), *rev'd on other grounds*, 940 F.2d 1306 (9th Cir. 1991); *In re* Stop & Go of Am., Inc., 49 B.R. 743, 747–48 (Bankr. D. Mass. 1985); *In re Tureaud*, 45 B.R. at 662–63.

[25] Paloian v. LaSalle Bank, N.A., 619 F.3d 688, 695 (7th Cir. 2010).

[26] *E.g.*, *Colonial Realty Co.*, 966 F.2d at 61; *In re* Bonham, 226 B.R. 56, 76–77 (Bankr. D. Alaska 1998), *aff'd*, 229 F.3d 750 (9th Cir. 2000); *In re* Circle Land & Cattle Corp., 213 B.R. 870, 874–76 (Bankr. D. Kan. 1997).

[27] *See, e.g.*, *Colonial Realty Co.*, 966 F.2d at 60–61 (consolidating estates of general partnership and two of its general partners) (citing cases); Eastgroup Props. v. S. Motel Ass'n, 935 F.2d 245, 252 (11th Cir. 1991) (consolidating limited partnership with related management corporation); *In re* Parkway Calabasas Ltd., 89 B.R. 832, 834–35 (Bankr. C.D. Cal. 1988) (consolidating estates of four limited partnerships and one of their principals), *aff'd,* 949 F.2d 1058 (9th Cir. 1991); *In re* Hedged-Invs. Assocs., Inc., 163 B.R. 841, 844, 849–50 (Bankr. D. Colo. 1994) (finding "no logical reason" why in the estate of a corporate entity, the general partner of at least two of three related limited partnerships could not be substantively consolidated with the consolidated partnership estates), *aff'd*, 84 F.3d 1286 (10th Cir. 1996); *In re* Palumbo Family Ltd. P'ship, 182 B.R. 447, 471 (Bankr. E.D. Va. 1995) (consolidating estates of limited partnership and individual general partner); *In re* Edwards Theatres Circuit, Inc., 281 B.R. 675, 677 n.1, 678 (Bankr. C.D. Cal. 2002) (bankruptcy estates of five California corporations and two Delaware limited liability companies, and their affiliates, substantively consolidated in confirmed chapter 11 plan); *In re* Ltd. Gaming of Am., Inc., 228 B.R. 275, 278–79, 287–89 (Bankr. N.D. Okla. 1998) (confirming liquidating plan which consolidated estates of limited partnership and its corporate partner).

Bankruptcy courts have also sanctioned the substantive consolidation of two or more entities *nunc pro tunc* in order to allow an agent or creditor to attack fraudulent transfers or avoidable preferences made by the debtor or consolidated entities as of the date of filing of the initial bankruptcy petition.[28]

B. Court's Authority to Grant Substantive Consolidation

The authority of a bankruptcy court to substantively consolidate two or more debtors is well established. That authority stems both from Section 105 of the Bankruptcy Code, which expressly empowers bankruptcy courts to issue any order necessary or appropriate to carry out the provisions of the Bankruptcy Code, and more generally, from the bankruptcy court's status as a court of equity.[29] See, for example, *Colonial Realty Co.*, 966 F.2d at 60 (citing Pepper v. Litton, 308 U.S. 295, 304 (1939)); *In re Bonham*, 226 B.R. at 75; and *In re* Standard Brands Paint Co., 154 B.R. 563, 567 (Bankr. C.D. Cal. 1993) (citing cases).

Additionally, many courts have held that bankruptcy courts also have the power under Section 105 to consolidate a bankruptcy debtor with an entity not in bankruptcy.[30] Some courts

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[28] *See, e.g.*, *In re* Baker & Getty Fin. Servs., Inc., 974 F.2d 712, 720 (6th Cir. 1992); *In re* Auto-Train Corp., 810 F.2d 270, 275–77 (D.C. Cir. 1987); *In re* Kroh Bros. Dev. Co., 117 B.R. 499, 502 (W.D. Mo. 1989).

[29] Some have argued that the cases that rely on the bankruptcy courts' general equitable powers as the source of authority for substantive consolidation are no longer good law after the decision of the U.S. Supreme Court in *Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, Inc.*, 572 U.S. 308 (1999) ("*Grupo Mexicano*"). In *Grupo Mexicano,* the Supreme Court held that a federal district court did not have judicial power to issue a preliminary injunction preventing a Mexican toll road operator from disposing of its assets pending adjudication of the plaintiff creditor's contract claim for money damages because such a remedy was historically unavailable from a court of equity. The Court noted that the equitable jurisdiction of the federal courts was derived from the Judiciary Act of 1789 (§ 11, 1 Stat. 78), and that a long line of U.S. Supreme Court cases had limited equitable jurisdiction to only that exercised by the English High Court of Chancery at the time of the adoption of the U.S. Constitution and the enactment of the original Judiciary Act, 1789 (1 Stat. 73). Consequently, the argument is that the equitable remedy of substantive consolidation is not a valid exercise of judicial power since it did not exist in the English Court of Chancery in 1789. Douglas A. Baird, *Substantive Consolidation Today*, 47 B.C. L. REV. 5, 20 (Dec. 2005); *see also* Simon Bowmer, *To Pierce or Not to Pierce the Corporate Veil: Why Substantive Consolidation is Not an Issue Under English Law*; 15 J. INT'L BANKING L. 193 (Issue 8, August 2000) (noting that English courts have not followed the lead of American courts in developing substantive consolidation doctrine). This argument was rejected in *In re Stone & Webster, Inc.*, 286 B.R. 532, 537–38 (Bankr. D. Del. 2002), *In re NM Holding Co., LLC, et al.*, 407 B.R. 232, 273–74 (Bankr. E.D. Mich. 2009), and *In re American Homepatient, Inc.,* 298 B.R. 152, 165 (Bankr. M.D. Tenn. 2003), determined to be inapplicable by the holding of the Supreme Court in *Sampsell*, *supra*, in *In re* Owens Corning*,* 419 F.3d 195 (3d Cir. 2005) and discussed, but not ruled upon, in *In re Amco Ins.,* 444 F.3d 690 (5th Cir. 2006).

[30] *See In re Bonham*, 226 B.R. at 75 ("[I]n what appears to be a slight majority of the cases which have decided the issue, courts have held that the estate of a non-debtor can be consolidated into that of a debtor under appropriate circumstances."); *In re* Creditors Serv. Corp., 195 B.R. 680, 689 (Bankr. S.D. Ohio 1996); *In re* New Ctr. Hosp., 187 B.R. 560, 566–67 (E.D. Mich. 1995); *In re* United Stairs Corp., 176 B.R. 359, 368 (Bankr. D.N.J. 1995); *In re* Gucci, 174 B.R. 401, 413 (Bankr. S.D.N.Y. 1994) ("[I]t is not a requirement that all the entities be debtors."); *In re* Munford, Inc., 115 B.R. 390, 396–97 (Bankr. N.D. Ga. 1990) (citing Sampsell v. Imperial Paper & Color Corp., 313 U.S. 215 (1941)). *But see In re* Circle Land & Cattle Corp., 213 B.R. 870, 877 (Bankr. D. Kan. 1997) (determining that because bankruptcy court lacks subject-matter jurisdiction over non-debtor, it cannot consolidate debtor with non-debtor); *In re* Julien Co., 120 B.R. 930, 934 (Bankr. W.D. Tenn. 1990) (questioning bankruptcy court's power under section 105 of the Bankruptcy Code to consolidate a non-debtor); *In re* Alpha & Omega Realty, Inc., 36 B.R. 416, 417 (Bankr. D. Idaho 1984) (concluding that non-debtor status of entity precluded consolidation); *In re* Fesco Plastics Corp., 996 F.2d

have argued that the consolidation of a debtor with a non-debtor essentially circumvents the requirements in Section 303 of the Bankruptcy Code for filing an involuntary bankruptcy petition against the non-debtor.[31] Other courts, however, have rejected this argument.[32]

Of course, a court may also permit substantive consolidation if the applicable parties agree. Thus, if the requisite vote is obtained, and a reorganization plan is confirmed, merger or consolidation can occur pursuant to Section 1123(a)(5)(C) of the Bankruptcy Code. In such instances, the assets of the consolidated entities will be used to pay the claims of the consolidated entities, either in accordance with the absolute priority rule set out in the Bankruptcy Code or as otherwise agreed by all parties.[33]

C. Standards for Substantive Consolidation

The standards for substantive consolidation have evolved exclusively through case law, not by statute. Although Sections 302 and 1123(a)(5)(C) of the Bankruptcy Code refer to "consolidation," they do not articulate a legal standard for substantive consolidation. Additionally, Rule 1015(b) of the Federal Rules of Bankruptcy Procedure expressly permits the "joint administration" of separate debtors' estates, but the Official Advisory Committee Note to Rule 1015(b) makes it clear that Rule 1015(b) has nothing to do with substantive consolidation.[34]

In determining whether substantive consolidation is appropriate, courts have analyzed a multitude of factors in lieu of applying a rigid, bright-line test. These factors include:

1. Common Ownership or Control.

Common ownership or control of the debtor and the sought to be consolidated entities increases the likelihood of consolidation, but will not by itself result in consolidation.[35]

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152 (7th Cir. 1993); *In re* Colfor, Inc., No. 96-60306, 1997 WL 605100, at *2 (Bankr. N.D. Ohio Sept. 4, 1997); *In re* Schwinn Bicycle, 210 B.R. 747 (Bankr. N.D. Ill. 1997); *In re* Deltacorp, Inc., 111 B.R. 419, 420–21 (Bankr. S.D.N.Y. 1990).

[31] *See In re Circle Land & Cattle Corp.*, 213 B.R. at 877; *In re* Lease-A-Fleet, Inc., 141 B.R. 869, 875 (Bankr. E.D. Pa. 1992); *In re* R.H.N. Realty Corp., 84 B.R. 356, 358 (Bankr. S.D.N.Y. 1988).

[32] *E.g.*, *In re* Alico Mining, Inc., 278 B.R. 586, 588–89 (Bankr. M.D. Fla. 2002) (rejecting involuntary-bankruptcy limitation, but requiring the party seeking substantive consolidation of debtor with non-debtor to establish that debtor is nothing more than alter ego of non-debtor); *In re Munford*, 115 B.R. at 397–98.

[33] *See In re* Stone & Webster, Inc., 286 B.R. 532, 542, 545 n.8, 546 (Bankr. D. Del. 2002) (reserving the examination of facts of a Chapter 11 case bearing upon numerous substantive consolidation factors and concomitant determination of whether substantive consolidation is warranted).

[34] *In re Bonham*, 226 B.R. at 76.

[35] *E.g., In re* Orfa Corp. of Phila., 129 B.R. 404, 415 (Bankr. E.D. Pa. 1991) (citing cases); *In re* DRW Prop. Co., 54 B.R. 489, 495–96 (Bankr. N.D. Tex. 1985).

2. Identical or Overlapping Officers or Directors.

When the debtor and the entities sought to be consolidated have identical or overlapping officers or directors, this increases the likelihood of consolidation, but is not controlling.[36]

3. Consolidated Tax Returns or Financial Reporting.

When the debtor and its affiliates file consolidated tax returns, or report their assets and liabilities on a consolidated basis in financial statements or Securities and Exchange Commission documents, consolidation becomes more likely.[37] Consolidated tax returns and financial statements, standing alone, normally do not warrant substantive consolidation.[38]

4. Inter-Affiliate Debts or Guarantees.

The presence of numerous inter-affiliate debts or guarantees among the affiliates being consolidated typically weighs in favor of consolidation, particularly if such debts or guarantees would be difficult or costly to untangle.[39] A court can also rely on a creditor's acceptance of an inter-corporate guarantee as evidence that the creditor knew of the consolidated nature of the debtor's businesses and did not rely on the separate credit of any entity being consolidated in extending credit.[40] By contrast, some courts have interpreted the existence of an inter-affiliate guarantee as evidence that creditors dealt with the entity being consolidated as economically separate and distinct.[41]

5. Undercapitalization.

When the affiliates being consolidated are grossly undercapitalized for their business

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[36] *See, e.g.*, *In re* Ltd. Gaming of Am., Inc., 228 B.R. 275, 288 (Bankr. N.D. Okla. 1998); *In re Lease-A-Fleet*, 141 B.R. at 871, 877; *In re* Buckhead Am. Corp., 1992 U.S. Bankr. LEXIS 2506 (Bankr. D. Del. Aug. 13, 1992); *In re* Drexel Burnham Lambert Grp. Inc., 138 B.R. 723, 766 (Bankr. S.D.N.Y. 1992).

[37] *See, e.g.*, *In re* Food Fair, Inc., 10 B.R. 123, 126 (Bankr. S.D.N.Y. 1981). *Compare In re* Mars Stores, Inc., 150 B.R. 869, 880 (Bankr. D. Mass. 1993) (consolidated financials in 10-Q weighed in favor of consolidation), *with In re* Auto-Train Corp., 810 F.2d 270, 278 (D.C. Cir. 1987) (S-1 registration statement supported creditor's claim of reliance on separate credit of entity sought to be consolidated).

[38] *In re* KRSM Props., Inc., 318 B.R. 712, 719–20 (B.A.P. 9th Cir. 2004); *In re* World Access, Inc., 301 B.R. 217, 276 (Bankr. N.D. Ill. 2003); *In re* Snider Bros., Inc., 18 B.R. 230, 233–34 (Bankr. D. Mass. 1982).

[39] *See, e.g.*, *In re* Standard Brands Paint Co., 154 B.R. 563, 568, 572 (Bankr. C.D. Cal. 1993); *In re Buckhead Am. Corp.*, 1992 U.S. Bankr. LEXIS 2506; *see also In re Drexel Burnham*, 138 B.R. at 766; *In re* GC Cos., 274 B.R. 663, 674–75 (Bankr. D. Del. 2002); *In re Food Fair, Inc.*, 10 B.R. 123, 126.

[40] *E.g.*, *In re* Snider Bros., Inc., 18 B.R. at 238 n.5.

[41] *See, e.g.*, *In re* Donut Queen, Ltd., 41 B.R. 706, 711 (Bankr. E.D.N.Y. 1984) (noting that a creditor "required the additional assurances of two distinct economic entities and required formal guarantees in recognition that they were indeed distinct"); *In re* Augie/Restivo Baking Co., 860 F.2d 515, 518 (2d Cir. 1988).

undertakings, the likelihood of consolidation increases.[42]

6. Commingling of Assets or Business Functions.

The debtor's commingling of assets or business functions with its affiliates weighs in favor of consolidation, but generally is not dispositive, unless the commingling is so extensive as to make the separation of the entities' assets impossible or not cost-effective.[43] Consolidation may also be appropriate where the debtor and its affiliates are functionally integrated, if other factors favoring consolidation are present.[44] Functional integration factors may include financing of a subsidiary, payment by the parent of salaries, expenses and losses of the subsidiary, the lack of business and assets of the subsidiary, except for those provided by the parent, and when the parent refers to the subsidiary as a department or division.

7. Failure to Maintain Corporate and Other Formalities.

The failure of the debtor to maintain corporate formalities, particularly in dealings with its affiliates, weighs in favor of substantive consolidation; but without more, this may not warrant consolidation except in the most egregious cases.[45]

8. Fraudulent or Preferential Transfers.

When significant fraudulent or preferential transfers exist between the debtor and the entity being consolidated, courts sometimes will grant consolidation to obviate the cost of avoiding or recovering such transfers.[46] Other courts, however, have held that the traditional statutory methods for avoiding and recovering such transfers expressly provided in the Bankruptcy Code are always preferable to the more radical remedy of substantive consolidation.[47]

9. Fraudulent or Inequitable Use of an Affiliate.

When the debtor uses an affiliate to hide or perpetrate fraud, to hinder creditors, or otherwise to advance an inequitable result, consolidation is likely.[48]

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[42] *See, e.g.*, *In re* 1438 Meridian Place, N.W., Inc., 15 B.R. 89, 96 (Bankr. D. D.C. 1981).

[43] *See, e.g.*, Soviero v. Franklin Nat'l Bank, 328 F.2d 446, 448 (2d Cir. 1964).

[44] *E.g.*, *In re Standard Brands*, 154 B.R. at 572.

[45] *See, e.g.*, *In re Snider Bros.*, 18 B.R. at 234; *In re* Buckhead Am. Corp., 1992 U.S. Bankr. LEXIS 2506 (Bankr. D. Del. Aug. 13, 1992); *see also Soviero*, 328 F.2d at 448 (featuring flagrant disregard of corporate forms); *In re* Tureaud, 45 B.R. 658, 660–61 (Bankr. N.D. Okla. 1985) (featuring egregious disregard of corporate formalities).

[46] *See, e.g.*, *In re Tureaud*, 59 B.R. at 977; *In re Standard Brands*, 154 B.R. at 571.

[47] *See, e.g.*, *In re* Lease-A-Fleet, Inc., 141 B.R. 869, 875–76 (Bankr. E.D. Pa. 1992); *In re* Owens Corning, 419 F.3d 195, 210 (3d Cir. 2005).

[48] *See, e.g.*, Sampsell v. Imperial Paper & Color Corp., 313 U.S. 215, 216 (1941); Maule Indus., Inc. v. Gerstel, 232 F.2d 294, 297 (5th Cir. 1956); *In re Tureaud*, 45 B.R. at 660.

10. Economic Benefits of Consolidation.

A factor frequently considered by courts is the potential profitability of consolidating the debtor and its related entities.[49] Consolidation has been granted where it improved the debtor's chances for a successful financial reorganization.[50]

11. Degree of Difficulty in Segregating Assets and Liabilities.

An extremely probative and sometimes decisive factor in consolidation decisions is the degree of difficulty in segregating the various entities' respective assets and liabilities. Consolidation may be granted if the entities' assets and liabilities are so entangled that their segregation is impossible or can be achieved only at great expense.[51]

12. Reliance on Separate Credit of Entities to be Consolidated.

In honoring settled commercial expectations, courts frequently deny consolidation where objecting creditors have reasonably relied on the separate credit of one of the entities being consolidated.[52] However, a creditor may be estopped from asserting such reliance where the creditor knew or should have known of the close association of the debtor and the entities sought to be consolidated.[53] Alternatively, if creditors have dealt with the debtor and its related entities as a single integrated entity, that fact weighs in favor of consolidation.[54]

13. Prejudice or Benefit to Creditors.

Inequitable prejudice to creditors of one entity may preclude consolidation.[55] However, the fact that some creditors will be adversely affected by consolidation is

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[49] *See, e.g.*, *In re* Vecco Constr. Indus., Inc., 4 B.R. 407, 410 (Bankr. E.D. Va. 1980).

[50] *See, e.g.*, *In re* Orfa Corp., 129 B.R. 404, 414–15 (Bankr. W.D. Pa. 1991) (citing *In re* F.A. Potts & Co., 23 B.R. 569, 572 (Bankr. E.D. Pa. 1982)).

[51] *See In re* Augie/Restivo Baking Co., 860 F.2d 515, 519 (2d Cir. 1988); *In re* Drexel Burnham Lambert Grp. Inc., 138 B.R. 723, 766 (Bankr. S.D.N.Y. 1992). *But see In re* DRW Prop. Co., 54 B.R. 489, 496–97 (Bankr. N.D. Tex. 1985) (refusing to grant consolidation even though it would cost over two million dollars to disentangle the various entities).

[52] *See, e.g.*, *In re Augie/Restivo Baking Co.*, 860 F.2d at 515; *In re* Auto-Train Corp., 810 F.2d 270, 277–78 (D.C. Cir. 1987).

[53] Eastgroup Props. v. S. Motel Ass'n, 935 F.2d 245, 249 n.11 (11th Cir. 1991) (*citing In re* Snider Bros., Inc., 18 B.R. 230, 235, 237, 233 (Bankr. D. Mass. 1982)).

[54] *Compare In re* Leslie Fay Cos., Inc., 207 B.R. 764, 780 (Bankr. S.D.N.Y. 1997) (granting consolidation), *and In re* Munford, Inc., 115 B.R. 390, 395–96 (Bankr. N.D. Ga. 1990) (granting consolidation), *with In re* Crown Mach. & Welding, Inc., 100 B.R. 25, 28 (Bankr. D. Mont. 1989) (refusing to consolidate even though creditors believed they were dealing with one entity).

[55] *See, e.g.*, *In re Augie/Restivo Baking Co.*, 860 F.2d at 517–19 (refusing to consolidate where secured lender's unsecured deficiency claim would have been subordinated as a result).

not always controlling.[56] Thus, if consolidation would directly benefit certain creditors, it may be granted over the objections of other creditors.[57] The court will balance the equities of the situation.

14. Individual or Non-Debtor Status of Entities to be Consolidated.

As discussed above, a number of courts have expressed reluctance to consolidate a debtor with individuals or with entities that are not themselves bankruptcy debtors. Accordingly, in such cases, a higher standard for consolidation may be imposed.[58]

D. Methodologies for Applying Substantive Consolidation Factors

As the overriding concern guiding the application of the above factors is the equitable treatment of creditors, the central inquiry in evaluating a motion for substantive consolidation is whether the economic prejudice resulting from continued recognition of the entities' separateness outweighs the economic prejudice that would be caused by the entities' consolidation.[59] The bankruptcy court presiding over a consolidation hearing will conduct a factually intensive inquiry and carefully balance the competing interests of all constituencies. Generally, the burden of proof is on the party seeking consolidation, presenting evidence using the factual criteria set forth above. The federal courts have implemented different approaches for analyzing the numerous factors discussed above. Three basic methodologies have emerged.[60] They are as follows:

1. First Methodology.

The first methodology relies on the factors listed above, or some subset thereof, as a means for measuring the equities, benefits, and detriments of consolidation.[61] According to this view, no one factor is decisive, and not all of the factors favoring consolidation need to be present in order for consolidation to be justified.[62] In situations where some factors favoring consolidation are present to a significant degree, but other critical factors are absent or are in conflict, a court nonetheless may

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[56] *In re* Murray Indus., Inc., 119 B.R. 820, 828 (Bankr. M.D. Fla. 1990).

[57] *E.g.*, *Eastgroup Props.*, 935 F.2d at 251 (permitting consolidation in part because it would increase the pro rata distribution to priority creditors).

[58] *See, e.g.*, *In re* Lease-A-Fleet, Inc., 141 B.R. 869, 874–76 (Bankr. E.D. Pa. 1992) (noting that consolidation of a non-debtor "should be reserved for unusual circumstances"); *In re* Julien Co., 120 B.R. 930, 935 (Bankr. W.D. Tenn. 1990) (noting that the bankruptcy trustee's attempt to consolidate assets of an individual contemplated "a "broader and much more invasive result").

[59] *E.g.*, *Eastgroup Props.*, 935 F.2d at 249 (quoting *In re* Snider Bros., Inc., 18 B.R. 230, 234 (Bankr. D. Mass. 1982)).

[60] *See generally In re* Bonham, 226 B.R. 56, 81–83 (Bankr. D. Alaska 1998), *aff'd*, 229 F.3d 750 (9th Cir. 2000).

[61] *See, e.g.*, *In re* Creditors Serv. Corp., 195 B.R. 680, 690 (Bankr. S.D. Ohio 1996) ("The factors merely provide the framework to assist the Court's inquiry whether harm will result in the absence of consolidation."); *In re* Vecco Constr. Indus., Inc., 4 B.R. 407, 410 (Bankr. E.D. Va. 1980).

[62] *E.g.*, *In re* Orfa Corp. of Phila., 129 B.R. 404, 415 (Bankr. E.D. Pa. 1991).

conclude that Substantive Consolidation is sufficiently beneficial to be appropriate.[63] Courts following this approach, however, generally place the burden on the proponent of consolidation of proving that the benefits from consolidation outweigh any resulting prejudice.[64]

2. Second Methodology.

The United States Court of Appeals for the Second Circuit has articulated a similar, but not identical, methodology that has gained acceptance in a number of courts. This standard treats the relevant factors outlined above as mere variants of two critical criteria: (i) whether creditors dealt with the entities being consolidated as a single economic unit and did not rely on their separate identity in extending credit; and (ii) whether the affairs of the sought to be consolidated entities are so entangled that consolidation will benefit all creditors because segregating the entities' respective affairs is impossible or so costly as to threaten the realization of any net assets for creditors.[65] If the proponent of consolidation establishes that either of these criteria is satisfied, consolidation may be granted.[66]

3. Third Methodology.

The third methodology has been adopted in the Eleventh and District of Columbia Circuits.[67] This standard allows the proponent of consolidation to establish a prima facie case for consolidation by demonstrating (i) a substantial identity between the entities sought to be consolidated, and (ii) that consolidation is necessary to avoid some harm or to realize some benefit.[68] The proponent of consolidation may rely upon the usual factors relied on in substantive consolidation cases, or some subset thereof, to prove either or both elements of the prima facie case.[69] Upon establishing a prima facie case, the burden shifts to objecting creditors to prove that they reasonably relied on the separate credit of one of the entities sought to be consolidated in extending credit and that they would be prejudiced by consolidation.[70] If a creditor proves reasonable reliance and prejudice, consolidation may be granted only if its

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[63] *Id.*

[64] *E.g.*, *In re* Crown Mach. & Welding, Inc., 100 B.R. 25, 27 (Bankr. D. Mont. 1989) (citing *In re* Steury, 94 B.R. 553, 554 (Bankr. N.D. Ind. 1988)); *In re Snider Bros.*, 18 B.R. at 238.

[65] *See In re* Augie/Restivo Baking Co., 860 F.2d 515, 518–19 (2d Cir. 1988); *see also* Fed. Deposit Ins. Corp. v. Colonial Realty Co., 966 F.2d 57, 61 (2d Cir. 1992) (affirming the *Augie/Restivo* standard); *In re Bonham*, 226 B.R. at 76.

[66] *In re* Standard Brands Paint Co., 154 B.R. 563, 569 (Bankr. C.D. Cal. 1993).

[67] *See* Eastgroup Props. v. S. Motel Ass'n, 935 F.2d 245 (11th Cir. 1991); *see In re* Auto-Train Corp., 810 F.2d 270 (D.C. Cir. 1987).

[68] *Eastgroup Props.*, 935 F.2d at 249; *In re Auto-Train Corp.*, 810 F.2d at 276.

[69] *Eastgroup Props.*, 935 F.2d at 249; *In re Auto-Train Corp.*, 810 F.2d at 276.

[70] *Eastgroup Props.*, 935 F.2d at 249.

> benefits "heavily outweigh" its detriments.[71] If such a creditor fails to prove either reasonable reliance or prejudice, however, consolidation may be granted regardless of whether the benefits of consolidation "heavily outweigh" its detriments.[72]

The courts for the District of Delaware have, in the past, relied upon both the second and third methodologies in making substantive consolidation determinations without declaring a preference for one methodology over the other, and without enouncing a new legal standard.[73] However, the Third Circuit in *In re Owens Corning,*[74] expressly rejected the "checklist" approach of the first methodology and the "balance of benefit and harm" approach of the third methodology, and stated, "if presented with a choice of analytical avenues, we favor essentially that of *Augie/Restivo*."[75] The Third Circuit determined that substantive consolidation is warranted if "(i) prepetition. . .[the entities] disregarded separateness so significantly [that] their creditors relied on the breakdown of entity borders and treated them as one legal entity, or (ii) postpetition [sic] their assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors."[76]

Substantive consolidation is a powerful tool for a bankruptcy court presiding over the cases of related entities whose financial affairs are hopelessly entangled or whose corporate separateness has been ignored by either its shareholders or creditors. "[S]ubstantive consolidation should be used only after it has been determined that all creditors will benefit because untangling is either impossible or so costly as to consume the assets."[77] So what will happen to Mr. Castle and his empire? Assuming the bondholders are successful in filing bankruptcy petitions against several of the Castle entities, based on the facts, Mr. Castle may have a hard time preventing the consolidation of his holdings, both public and private.

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[71] *Eastgroup Props.*, 935 F.2d at 249; *In re Auto-Train Corp.*, 810 F.2d at 276.

[72] *E.g.*, *In re* New Ctr. Hosp., 187 B.R. 560, 569 (E.D. Mich. 1995) ("Since reliance and prejudice have not been shown, the Court need not reach the issue of whether the benefits of consolidation 'heavily outweigh' the harm."); *see also Eastgroup Props.*, 935 F.2d at 249; *In re Auto-Train Corp.*, 810 F.2d at 276; *In re* Ltd. Gaming of Am., Inc., 228 B.R. 275, 287 (Bankr. N.D. Okla. 1998); *In re Standard Brands*, 154 B.R. at 568–69; *In re* Lewellyn, 26 B.R. 246, 251–52 (Bankr. S.D. Iowa 1982).

[73] *See In re* GC Cos., Inc., 298 B.R. 226, 231 (D. Del. 2003); *In re* Genesis Health Ventures, Inc., 266 B.R. 591, 618–19 (Bankr. D. Del. 2001); *In re* Stone & Webster, Inc., 286 B.R. 532, 539 (Bankr. D. Del. 2002) (bankruptcy court has great flexibility to tailor its relief to ensure equitable treatment of all creditors).

[74] *In re* Owens Corning*,* 419 F.3d 195, 211–12 (3d Cir. 2005).

[75] *Id.* at 210.

[76] *Id.* at 211 (footnote omitted).

[77] *In re* Augie/Restivo Baking Co., 860 F.2d 515, 519 (2d Cir. 1988); *In re Owens Corning,* 419 F.3d at 210.

FIDUCIARY DUTIES AND MINORITY SHAREHOLDER OPPRESSION FROM THE DEFENSE PERSPECTIVE:

DIFFERING APPROACHES IN TEXAS, DELAWARE, AND NEVADA

George Parker Young, Vincent P. Circelli, & Kelli L. Walter

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I. INTRODUCTION

Suits by minority shareholders in Texas are on the rise and represent an expanding, cutting-edge area of civil litigation in this state and across the country. While the Texas Supreme Court and several appellate courts in Texas have yet to recognize a cause of action for shareholder oppression or to define its parameters, a growing number of courts have upheld claims for shareholder oppression or at least recognized it as a viable claim. But these courts' justifications for recognizing a broad shareholder oppression claim are questionable, because they rely on: (1) a Texas Supreme Court case that never blessed shareholder oppression as a valid claim; (2) a Texas receivership statute that allows relief from oppression only in limited and extreme circumstances; and (3) a Texas appellate court case that relied on the previous two faulty grounds and on inapplicable case law from other jurisdictions. The Texas Supreme Court recently granted review to a shareholder oppression case (*Ritchie v. Rupe*), and will confront this issue in the very near future. Argument was heard on February 26, 2013.

Given the paucity of Texas precedent in the area of shareholder oppression, Texas courts often look to Delaware law for guidance on business issues, given the specialized nature of Delaware courts considering business disputes.[1] In addition, because of the "Internal Affairs Doctrine," Delaware law can apply to a suit filed in Texas if the corporation or LLC is chartered in Delaware. The Texas practitioner must be familiar with the differences between Texas and Delaware law, and the circumstances that can trigger the application of Delaware rather than Texas substantive law.

This article first addresses fiduciary duty requirements in Texas and Delaware, and the mechanisms available under the "Internal Affairs Doctrine" that may mandate the application of another state's law instead of Texas' in the context of fiduciary and shareholder litigation. There follows a discussion of Texas law on the evolving legal theory of "Minority Shareholder Oppression." As will be seen, unlike the broad and amorphous formulation of the doctrine some Texas Courts of Appeals have adopted (absent meaningful guidance so far from the state's supreme court), Delaware has rejected the Texas lower courts' approach of adopting a vague and general, almost standard-less cause of action called "shareholder oppression," in favor of a case-specific approach designed to protect minority shareholders in limited circumstances, such as squeeze-out mergers and freeze-outs. Delaware courts do this mostly through the way they interpret fiduciary and disclosure duties as well as minority shareholder appraisal rights. Finally, this paper concludes with a brief analysis of minority shareholder oppression in Nevada, a state that is seen as an increasingly attractive alternative forum for incorporation.

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[1] *See, e.g.*, Grant Thornton LLP v. Prospect High Income Fund, 314 S.W.3d 913, n.19 (Tex. 2010) (citing Delaware law for the proposition that individual shareholder claims remain state law actions); *In re* Schmitz, 285 S.W.3d 451, 457 (Tex. 2009) (citing Delaware law to hold that a demand-required derivative suit must name the shareholder on whose behalf it is made); Int'l Bankers Life Ins. Co. v. Holloway, 368 S.W.2d 567, 570 (Tex. 1963) (citing Guth v. Loft, Inc., 5 A.2d 503 (Del. 1939)); Neurobehavioral Assocs., P.A. v. Cypress Creek Hosp., Inc., 995 S.W.2d 326, 328–29 (Tex. App.—Houston [1st Dist.] 1999, no pet.) (relying on Rothschild Int'l Corp. v. Liggett Group, Inc., 474 A.2d 133, 136 (Del.1984)).

II. BREACH OF FIDUCIARY DUTY

A. Fiduciary Duties in Texas and Delaware

In Texas, fiduciary duties arise in one of two ways: (1) a formal fiduciary relationship can exist as a matter of law between two parties; or (2) an informal fiduciary relationship may arise from the facts of the case.[2] As discussed below, officers, directors, and majority shareholders owe formal fiduciary duties to the corporations they serve. But fiduciary duties may exist between other corporate actors if the facts support an informal fiduciary relationship.

Informal fiduciary duties arise under Texas law "from a confidential relationship 'where one person trusts in and relies upon another, whether the relation is moral[,] social, domestic[,] or merely personal.'"[3] Mere subjective trust, however, is insufficient to create such a duty.[4] Rather, the reliance must be justified.[5] To impose an informal fiduciary relationship in a business transaction, "the relationship must exist prior to, and apart from the agreement made the basis of the suit."[6] Creation of an informal fiduciary relationship is a fact-specific inquiry.[7]

Officers and directors owe fiduciary duties to the corporations they serve as a matter of law.[8] Officers and directors do not, however, owe formal fiduciary duties to the corporation's shareholders.[9]

In 2003, the Texarkana Court of Appeals created confusion on this point by stating, "It has been well established that the directors of a corporation stand in a fiduciary relationship to the corporation *and its stockholders* . . . ."[10] *Pinnacle Data Services* should not be interpreted, however, to impose fiduciary duties on officers and directors to individual shareholders. First, the case on which *Pinnacle Data Services* relies to support this proposition does not indicate

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[2] Hoggett v. Brown, 971 S.W.2d 472, 487 (Tex. App.—Houston [14th Dist.] 1997, pet. denied) (quoting Crim Truck & Tractor Co. v. Navistar Int'l Transp. Corp., 823 S.W.2d 591, 593–94 (Tex. 1992)).

[3] *Id.* (quoting Crim Truck & Tractor, 823 S.W.2d at 593–94, and Hallmark v. Port/Cooper, 907 S.W.2d 586, 592 (Tex. App.—Corpus Christi 1995, no writ)).

[4] Schlumberger Tech. Corp. v. Swanson, 959 S.W.2d 171, 177 (Tex. 1997).

[5] *See Hoggett*, 971 S.W.2d at 488 ("A person is justified in placing confidence in the belief that another party will act in his or her best interest only where he or she is accustomed to being guided by the judgment or advice of the other party, and there exists a long association in a business relationship, as well as personal friendship.").

[6] Willis v. Donnelly, 199 S.W.3d 262, 277 (Tex. 2006) (quoting *Schlumberger Tech. Corp.*, 959 S.W.2d at 177).

[7] *See id.* (stating that an informal fiduciary duty may arise from the facts of the case) (citing *Schlumberger Tech. Corp.*, 959 S.W.2d at 177).

[8] *See* Int'l Bankers Life Ins. Co. v. Holloway, 368 S.W.2d 567, 576 (Tex. 1963); Landon v. S&H Marketing Group, Inc., 82 S.W.3d 666, 672 (Tex. App.—Eastland 2002, no pet.).

[9] Myer v. Cuevas, 119 S.W.3d 830, 836 (Tex. App.—San Antonio 2003, no pet.) ("Corporate officers do not owe fiduciary duties to individual shareholders unless a contract or special relationship exists between them in addition to the corporate relationship."); *Hoggett*, 971 S.W.2d at 48 ("A director's fiduciary duty runs only to the corporation, not to individual shareholders or even to a majority of the shareholders.").

[10] Pinnacle Data Servs. v. Gillen, 104 S.W.3d 188, 198 (Tex. App.—Texarkana 2003, no pet.) (emphasis added).

that such a duty exists.[11] Second, this statement in *Pinnacle Data Services* should be interpreted consistent with an earlier decision by the same court, where it held, "[a] corporate officer [and director] owes a fiduciary duty to the shareholders collectively, [i.e.] the corporation, but he does not occupy a fiduciary relationship with an *individual* shareholder."[12] Such an interpretation brings *Pinnacle Data Services* in line with the wealth of other Texas cases holding that officers and directors do not owe fiduciary duties to individual shareholders absent an informal fiduciary relationship.

1. Fiduciary Duties Under Texas Law

Three broad duties stem from officers' and directors' roles as fiduciaries in Texas: duties of obedience, loyalty, and due care.[13]

a. Duty of Obedience

The duty of obedience "requires a director to avoid committing *ultra vires* acts, [i.e.], acts beyond the scope of the powers of a corporation as defined by its charter or the laws of the state of incorporation."[14] An officer or director will only be personally liable for such *ultra vires* acts if his actions are also illegal.[15]

b. Duty of Loyalty and the Safe Harbor Defense

The duty of loyalty "requires an extreme measure of candor, unselfishness, and good faith on the part of the officer or director."[16] Stated another way, the duty of loyalty "dictates that a corporate officer or director must act in good faith and must not allow his or her personal interest to prevail over the interest of the corporation."[17] An officer or director is considered "interested" when he "makes a personal profit from a transaction by dealing with the corporation or usurps a corporate opportunity."[18] A corporate opportunity "arises when a corporation has a legitimate interest or expectancy in, and the financial resources to take advantage of, a particular business opportunity."[19] In addition, an officer or director is considered "interested" when he "buys or sells assets of the corporation," "transacts business in his director's capacity with a second corporation of which he is also a director or significantly financially associated," or "transacts business in his director's capacity with a

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[11] *Compare id. with* Duncan v. Bushey, 263 S.W.2d 148, 151–52 (Tex. 1953) (allowing shareholders to challenge directors' actions, because the corporate charter had been forfeited).

[12] Faour v. Faour, 789 S.W.2d 620, 621 (Tex. App.—Texarkana 1990, writ denied).

[13] Gearhart Indus., Inc. v. Smith Int'l, Inc., 741 F.2d 707, 719 (5th Cir. 1984) (applying the duties to directors, but recognizing that the fiduciary duties of officers are generally identical to those of directors); *Landon,* 82 S.W.3d 666, 672–73 (Tex. App.—Eastland 2002, no pet.) (applying the duties to officers and directors alike).

[14] *Gearhart*, 741 F.2d at 719.

[15] *Id.*

[16] *Pinnacle*, 104 S.W.3d at 199.

[17] *Landon*, 82 S.W.3d at 672.

[18] *Id*. at 673 (citing *Gearhart*, 741 F.2d at 719–20).

[19] Icom Sys., Inc. v. Davies, 990 S.W.2d 408, 410 (Tex. App.—Texarkana 1999, no writ) (citing Dyer v. Shafer, 779 S.W.2d 474, 477 (Tex. App.—El Paso 1989, writ denied)).

family member."[20]

When an officer or director enters into a contract with the corporation he serves, he should ensure that the transaction satisfies one of the safe harbor provisions contained in the Texas Business Organizations Code.[21] Specifically, such a transaction will be found valid in the following instances:

1. Upon the affirmative, good faith vote of a majority of disinterested directors provided that the material facts of the contract or transaction is disclosed to or known by the board;

2. Upon the affirmative, good faith vote of the shareholders provided that the material facts of the contract or transaction is disclosed to or known by the shareholders; or

3. The contract or transaction is fair as to the corporation as of the time that it is authorized, approved, or ratified by the board of directors or shareholders.[22]

c. Duty of Care and the Business Judgment Rule Defense

Texas courts have defined the duty of care to prohibit an officer's or director's negligent management of a corporation.[23]

Other courts, while appearing to affirm this general standard of the duty of care, have defined the business judgment rule in such a way that completely obliterates the duty of care:

> This principle is known as the business judgment rule and it is a defense to accusations of breach of the duty of care . . . . Texas courts to this day will not impose liability upon a noninterested corporate director unless the challenged action is *ultra vires* or is tainted by fraud. Such is the business judgment rule in Texas.[24]

In other words, the business judgment rule shields a director from claims alleging a breach of the duty of care *unless* the director holds an interest and the decision was *ultra vires* or

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[20] *Landon*, 82 S.W.3d at 673 (citing *Gearhart*, 741 F.2d at 719–20).

[21] *See* TEX. BUS. ORGS. CODE ANN. § 21.418 (West Supp. 2010).

[22] *See Landon*, 82 S.W.3d at 673 (describing safe harbors found in TEX. BUS. CORP. ACT ANN. art. 2.35-1 (West Supp. 2002), which are substantially similar to those found in TEX. BUS. ORGS. CODE ANN. § 21.418).

[23] *See, e.g.*, Meyers v. Moody, 693 F.2d 1196, 1209 (5th Cir. 1983) ("Texas law imposes on corporate officers and directors a duty to exercise due care in the management of the corporation's affairs. If they breach that duty, they are liable to the corporation for any loss it may suffer as a result of their neglect. 'Due Care' is that degree of care which a person of ordinary prudence would exercise under the same or similar circumstances.") (citations omitted).

[24] *Gearhart*, 741 F.2d at 721 (citations omitted); *see also* Campbell v. Walker, No. 14-96-01425-CV, 2000 WL 19143, at *10 (Tex. App.—Houston [14th Dist.] June 13, 2000, no pet.) ("[F]or over a hundred year[s]—since 1889—Texas courts have refused to impose liability upon a non-interested corporate director who breached a fiduciary duty unless the challenged action is *ultra vires* or is tainted by fraud.") (emphasis added).

involved fraud.[25] But if any of these elements exists, the director will be liable for breach of another duty. If a director is interested with respect to the transaction, then the case implicates the duty of loyalty. If the challenged conduct is *ultra vires*, then the case implicates the duty of obedience. If the challenged conduct involves fraud, then the case implicates the duty of good faith component of the duty of loyalty or some other direct claim for fraud. Therefore, under *Gearhart*'s formulation of the business judgment rule, it is unclear how a plaintiff could assert a valid breach of fiduciary duty claim related to the fiduciary's duty of care that is distinct from a duty of loyalty or obedience claim. Thus, the way some Texas courts have described the business judgment rule strips the duty of care of all substance, essentially absolving directors and officers of all liability for duty of care claims.

Determining whether a director is "noninterested" involves a multi-part test. An "interested director" for purposes of the business judgment rule is one who: (1) makes a personal profit from a transaction dealing with the corporation or usurps a corporate opportunity; (2) buys or sells assets of the corporation; (3) transacts business in his director's capacity with a second corporation of which he is also a director or significantly financially associated; or (4) transacts business in his director's capacity with a family member.[26] Even then, such transactions are permitted if disclosed and approved by disinterested directors.

Additionally, other Texas courts have allowed the business judgment rule as a defense to decisions that were made with "due care."[27] Under this formulation, the business judgment rule provides great protection to directors and little or no protection to shareholders asserting duty of care claims.

Despite the lack of clarity on the duty of care and the business judgment rule under Texas law, Texas allows corporations to exculpate directors for duty of care claims.[28] Texas companies with exculpation clauses can avoid the uncertainty of Texas law regarding the duty of care and the business judgment rule by exculpating directors for all claims premised on the duty of care.

d. Majority Shareholder Fiduciary Duties

Several Texas courts have indicated that majority shareholders owe formal fiduciary duties to the corporations they control.[29] A majority shareholder does not owe formal fiduciary duties to other shareholders.[30] Indeed, the Texas Supreme Court has never recognized a formal

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[25] *Gearhart*, 741 F.2d at 721.

[26] *Gearhart*, 741 F.2d at 719–20; *see also* TEX. BUS ORGS. CODE, §§ 1.0003–.0004 (West 2010) (defining "Disinterested Person" and "Independent Person").

[27] *See, e.g.*, Van Bavel v. Oasis Design, Inc., No. 03-97-00434-CV, 1998 WL 546342, at *11 (Tex. App.—Austin Aug. 31, 1998, no pet.) (jury instructed that under the business judgment rule "a director will not be held liable for an honest mistake if he acted with *due care*[.]") (emphasis added).

[28] *See* TEX. BUS. ORGS. CODE ANN. § 7.001 (West Supp. 2010).

[29] *See* Hoggett v. Brown, 971 S.W.2d 472, 488, n.13 (Tex. App.—Houston [14th Dist.] 1997, pet. denied) ("[A] majority shareholder's fiduciary duty ordinarily runs to the corporation." (citing Schautteet v. Chester State Bank, 707 F. Supp. 885, 889 (E.D. Tex. 1988))).

[30] *Id.* at 488.

fiduciary relationship between shareholders.[31] Thus, a majority shareholder only owes fiduciary duties to another shareholder when the facts of the case justify creating an informal fiduciary relationship.[32] Courts have frequently declined to extend such a duty to minority shareholders.[33]

In determining if such a relationship exists, some courts have considered the degree to which the majority shareholder exercises control over the corporation.[34] In *Redmon v. Griffith*, the court indicated that corporate control, combined with oppressive conduct, was sufficient to allege the existence of informal fiduciary duties owed by the majority shareholder to the minority shareholder.[35] The court explained:

> The Redmons further allege facts indicating a great deal of control over the business exercised by Ralph Griffith. Such allegations combined with allegations in the Redmons' pleadings that the Griffiths engaged in wrongful conduct and a lack of fair dealing with regard to the company's affairs to the prejudice of the Redmons sufficiently alleges a breach of fiduciary duty by way of oppressive conduct.[36]

Because *Redmon* was a summary judgment case, the Tyler Court of Appeals did not have an opportunity to develop what evidence was sufficient to impose a fiduciary duty, since the plaintiff there only had to present "some evidence" to raise a fact issue concerning the alleged breach of fiduciary duty. Moreover, the court's reference to "fair dealing" implicates a duty of good faith and fair dealing between shareholders, which the Texas Supreme Court has been reluctant to adopt. *Redmon* also ignores the well-established requirements that must exist for an informal fiduciary relationship to be found in a business context, namely trust, justified reliance, and a relationship that existed prior to and apart from the agreement that forms the basis of the suit.

Ultimately, a majority shareholder cannot know with certainty if he owes fiduciary duties to a minority shareholder, because the relationship is determined on a case-by-case basis. But when a long-lasting relationship of trust and reliance exists, or when the majority shareholder exercises significant control over the corporation and engages in oppressive conduct, a court may conclude that a fiduciary relationship exists.

Even if there is no direct fiduciary duty owed to the minority shareholder, the minority shareholder can still bring a derivative claim on behalf of the close corporation for violation of duties owed the corporation.[37]

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[31] *See* Willis v. Donnelly, 199 S.W.3d 262, 276 (Tex. 2006) (declining to decide whether a majority shareholder owes a fiduciary duty to a minority shareholder as a matter of law).

[32] *See Hoggett*, 971 S.W.2d at 488. ("[A] co-shareholder in a closely held corporation does not as a matter of law owe a fiduciary duty to his co-shareholder. Instead, whether such a duty exists depends on the circumstances.").

[33] *See Willis*, 199 S.W.3d at 276.

[34] *See, e.g.*, *Hoggett*, 971 S.W.2d at 488 n.13 ("[I]n certain limited circumstances, a majority shareholder who dominates control over the business may owe such a duty to the minority shareholder.").

[35] Redmon v. Griffith, 202 S.W.3d 225, 238 (Tex. App.—Tyler 2006, pet. denied).

[36] *Id.*

[37] *See* TEX. BUS. ORGS. CODE ANN. § 21.563 (West Supp. 2010) (formerly TEX. BUS. CORP. ACT ANN. art.

2. Fiduciary Duties Under Delaware Law

The Delaware courts have held that minority shareholders' claims for mistreatment or oppressive conduct fall under the general law of corporate fiduciary duties of loyalty, care and good faith.[38] Under Delaware law, much like Texas, directors and officers owe the fiduciary duties of due care, loyalty, and good faith to the corporation.[39] However, under Delaware law, *unlike* Texas, directors owe fiduciary duties not only to the corporation but also directly to the shareholders.[40] In Texas, officers, directors, and controlling shareholders do not owe fiduciary duties directly to individual shareholders simply by virtue of their status as shareholders.[41] Delaware has clearly established that "a shareholder owes a fiduciary duty only if it owns a majority interest in or exercises control over the business affairs of the corporation."[42] Delaware courts have therefore stated that a "majority shareholder owes a fiduciary duty to the minority shareholders."[43]

a. The Duty of Care

The duty of care in Delaware imposes upon a director an obligation to exercise due care in the process of decision making as well as all other aspects of a director's responsibilities (i.e. delegation and oversight functions). The standard requires that a director, "in managing corporate affairs[,] [is] bound to use that amount of care which ordinarily careful and prudent men would use in similar circumstances."[44] Directors are held to this standard under gross negligence considerations, which equates to "reckless indifference to or a deliberate disregard of the whole body of stockholders" or actions which are "without the bounds of reason."[45]

Although requirements to comply with the duty of care vary depending upon the facts of a particular action, the duty is breached by the following board actions: (1) haste in decision making;[46] (2) lack of board preparation;[47] (3) lack of questioning or involvement by the board;[48] (4) lack of a paper record—reliance on officers or experts;[49] and (5) lack of care in

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5.14 (West Supp. 2002)).

[38] *See* Nixon v. Blackwell, 626 A.2d 1366,1380–81(Del. 1993).

[39] *See, e.g.*, N. Am. Catholic Educ. Programming Found. v. Gheewalla, 930 A.2d 92, 99 (Del. 2007).

[40] Emerald Partners v. Berlin, 787 A.2d 85, 90 (Del. 2001).

[41] *See* Massachusetts v. Davis, 168 S.W.2d 216, 221 (Tex. 1942); *see also* Cotten v. Weatherford Bancshares, Inc. 187 S.W.3d 687, 698 (Tex. App.—Fort Worth 2006, pet. denied) (holding that corporate officers do not owe fiduciary duties to individual shareholders unless a contract or confidential relationship exists between them).

[42] Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1344 (Del. 1987).

[43] Unocal Corp. v. Mesa Petroleum, 493 A.2d 946, 958 (Del. 1985) (citing Allied Chem. & Dye Corp. v. Steel & Tube Co. of Am., 120 A. 486, 491 (Del. Ch. 1923)).

[44] Graham v. Allis-Chalmers Manuf. Co., 188 A.2d 125, 130 (Del. 1963).

[45] Tomczak v. Morton Thiokol, Inc., C.A. No. 7861, slip op. at 31 (Del. Ch. Apr. 5, 1990).

[46] McMullin v. Beran, 765 A.2d 910, 922 (Del. 2000) ("The imposition of time constraints on a board's decision[]making process may compromise the integrity of its deliberative process."); Smith v. Van Gorkom, 488 A.2d 858, 870 (Del. 1985).

[47] *Smith*, 488 A.2d at 870.

[48] Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1267 n.7 (Del. 1988); *Smith*, 488 A.2d at 870.

[49] *Smith*, 488 A.2d at 870. Section 141(e) of the Delaware Code sets out three requirements which must be met for a director to rely on expert or officer reports: (1) good faith; (2) reasonable belief in the professional or expert

dealing with documents.[50] Commentators have noted that for each action taken by a board, the board must scrutinize the transaction as critically as practicable under the circumstances, take as much time as feasible and consider all reasonably available information.[51]

In addition, many Delaware corporations have an exculpatory provision in their corporate charters absolving corporate directors of liability for suits brought on behalf of the corporation for violations of the duty of care.[52] A proper exculpatory clause that complies with section 102(b)(7) of the Delaware Code prohibits suits on behalf of the company premised on gross negligence or the duty of care.[53] Section 102(b)(7), however, does not permit exculpatory provisions for "among other things, breaches of the duty of loyalty or actions or omissions not in good faith or that involve intentional misconduct or a knowing violation of the law."[54] Because many corporations have a section 102(b)(7) exculpatory clause, plaintiffs often attempt to turn duty of care claims into bad faith claims that are not precluded by an exculpatory provision. The Delaware Supreme Court has concluded that conduct that violates the duty of care likely also violates the requirement of good faith.

> [T]he universe of fiduciary misconduct is not limited to either disloyalty in the classical sense ([i.e.], preferring the adverse self-interest of the fiduciary or of a related person to the interest of the corporation) or gross negligence. Cases have arisen where corporate directors have no conflicting self-interest in a decision, yet engage in a misconduct that is more culpable than simple inattention or failure to be informed of all the facts material to the decision. To protect the interests of the corporation and its shareholders, fiduciary conduct of this kind, which does not involve disloyalty (as traditionally defined) but is qualitatively more culpable than gross negligence, should be proscribed. A vehicle is needed to address such violations doctrinally, and that doctrinal vehicle is the duty to act in good faith.[55]

b. The Duty of Loyalty

The duty of loyalty mandates that the best interests of the corporation and its shareholders take precedence "over any interest possessed by a director, officer[,] or controlling shareholder and not shared by the stockholders generally."[56] It requires strict compliance and restraint from self-dealing.

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competence of the person furnishing the report; and (3) that the expert has been selected with reasonable care "by or on behalf" of the corporation. DEL. CODE ANN. tit. 8, § 141(e).

[50] *Smith*, 488 A.2d at 870.

[51] *See* R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, 1 DELAWARE LAW OF CORPORATIONS & BUSINESS ORGANIZATIONS, § 4.34, at 4-240 (3d ed. 2006 supp.).

[52] *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (West 2013).

[53] *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 47 n.37, 67 (Del. 2006).

[54] *In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 124 (Del. Ch. 2009).

[55] *In re Walt Disney Co.*, 906 A.2d at 66.

[56] Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993).

A foundational Delaware case involving the duty of loyalty is *Guth v. Loft, Inc*.[57] In *Guth*, The Delaware Supreme Court held that a corporate officer violated his fiduciary duty to his corporation because the business opportunity presented to the officer was one which the corporation was financially able to undertake and was in the line of the corporation's business. Charles Guth ("Guth") was the president of Loft, Inc., which made a cola drink. Loft's soda fountains purchased cola syrup from Coca Cola, but Guth decided it would be less expensive to buy the syrup from Pepsi after Coca Cola declined to give him a discount. While negotiating the switch, Pepsi went bankrupt. Guth bought Pepsi's trademark and its syrup recipe, (which he had Loft chemists reformulate) and then purported to sell the syrup himself to Loft, Inc. Subsequently, Loft, Inc. filed a lawsuit against Guth, alleging that he had breached his fiduciary duty of loyalty to the corporation for failing to offer that opportunity to his company instead appropriating it to himself.

The Delaware Supreme Court laid out three principal factors to consider in evaluating a corporate opportunity issue: (1) whether or not the corporation has the financial ability to undertake the opportunity; (2) whether or not the opportunity is in the corporation's line of business and is of practical advantage to it; and (3) whether or not the corporation has an interest or reasonable expectancy in the opportunity.

The court concluded that the opportunity to acquire the Pepsi trademark and formula belonged to Loft, Inc. and that Guth violated his fiduciary duty to the corporation by taking the business opportunity for himself. When presented with a business opportunity that could be advantageous to the corporation, an officer is required to make that opportunity available to the corporation before pursuing the opportunity for himself. Otherwise, the self-interest of the officer would be brought into conflict with that of the corporation. The court stated that the officer could not receive a benefit from his breach of his fiduciary duty.

In certain circumstances, a board of directors may protect itself from potential breaches of this duty by individual directors through compliance with section 144 of the Delaware Code.[58] However, the Delaware Supreme Court stated:

> There is no "safe harbor" for . . . divided loyalties in Delaware. When directors of a Delaware corporation are on both sides of a transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain . . . . The requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of scrutiny by the courts.[59]

Thus, while an interested director transaction is not necessarily void or voidable, it is still subject to exacting court review.

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[57] Guth v. Loft, Inc., 5 A.2d 503 (Del. 1939).

[58] *See* DEL. CODE ANN. tit. 8, § 144 (2013).

[59] Weinberger v. U.O.P., Inc., 457 A.2d 701, 710 (Del. 1983).

c. The "Duty" of Good Faith and the Business Judgment Defense

Although the duty of good faith "may be described colloquially as part of a 'triad' of fiduciary duties" together with the duties of care and loyalty, the Delaware Supreme Court does not recognize good faith as an "independent fiduciary duty that stands on the same footing as the duties of care and loyalty."[60]

Rather than being an independent duty, the Delaware Supreme Court has clarified that good faith "is a subsidiary element, [i.e.], a condition, of the fundamental duty of loyalty."[61] Therefore, "a failure to act in good faith" does not result "*ipso facto*, in the direct imposition of fiduciary liability," though it is essential to impose liability for violation of the duty of loyalty.[62]

Delaware courts have also noted the interrelated working of the duty of good faith and the contractual responsibility of directors and members to act with "good faith and fair dealing" under an organization's formation documents.[63] The *Bay Center* court noted that "part of a corporate manager's proper performance of their contractual obligations is to use the discretion granted to them in the company's organizational documents in good faith."[64] It should be noted that the Delaware Supreme Court has recently undercut the rarely successful implied duty of good faith and fair dealing claims by repeating that "[w]e will only imply contract terms when the party asserting the implied covenant proves that the other party has acted arbitrarily or unreasonably, thereby frustrating the fruits of the bargain that the asserting party reasonably expected."[65] Importantly, the court went on to state that a "party does not act in bad faith by relying on contract provisions for which that party bargained, where doing so simply limits advantages to another party."[66]

Like Texas, the business judgment rule in Delaware protects officers and directors acting in good faith from liability in certain contexts.[67] Under Delaware law, the business judgment rule "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company."[68] The party challenging the board's decision has the burden of establishing facts rebutting the presumption.[69] "If the business judgment rule is not rebutted, a court will not substitute its judgment for that of the board if the board's decision can be

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[60] *See* Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006).

[61] *Id.* at 369–370 (citing Guttman v. Huang, 823 A.2d 492, 506 n.34 (Del. Ch. 2003).

[62] *Id.*

[63] *See, e.g.*, Bay Ctr. Apartments Owner, LLC v. Emery Bay PKI, LLC, No. 3658-VCS, 2009 WL 1124451 (Del. Ch. April 20, 2009).

[64] *Id.* at *7.

[65] Nemec v. Shrader, 2010 WL 1320918 (Del. Apr. 6, 2010).

[66] *Id.*

[67] *See, e.g.*, Robotti & Co. LLC v. Liddell, No. 3128-VCN, 2010 WL 157474 (Del. Jan. 14, 2010); STEPHEN RADIN, The Business Judgment Rule: Fiduciary Duties for Corporate Directors, (6th Ed. 2009).

[68] MM Cos. v. Liquid Audio, 813 A.2d 1118, 1127 (Del. 2003) (internal quotations omitted).

[69] *Id.*

attributed to any rational purpose."[70] In the context of a motion to dismiss based on the business judgment defense "the pled facts must support a reasonable inference that in making the challenged decision, the board of directors breached either its duty of loyalty or its duty of care."[71]

The business judgment rule in Delaware focuses on the reasonableness of the *process* by which a board came to a particular decision and is not concerned with *substance* of the decision:

> What should be understood, but may not widely be understood by courts or commentators who are not often required to face such questions, is that compliance with a director's duty of care can never appropriately be judicially determined by reference to *the content of the board decision* that leads to a corporate loss, apart from consideration of the good faith or rationality of the process employed. That is, whether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through "stupid" to "egregious" or "irrational", provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in a good faith effort to advance corporation interests. To employ a different rule—one that permitted an "objective" substantive second guessing by ill-equipped judges or juries, would, in the long-run, be injurious to investor interests. Thus, the business judgment rule is process oriented and informed by a deep respect for all good faith board decisions.[72]

Thus, the plaintiff must show gross negligence in the process by which corporate directors or officers made a decision to rebut the presumption of the business judgment rule.[73]

The Delaware Supreme Court has recently held that one particular decision protected by the business judgment rule is the decision to accept or reject a merger.[74] The *Gantler* court stated that in the context of mergers the board is entitled to a strong presumption in its favor, because implicit in the board's statutory authority to propose a merger is also the power to decline to do so.[75] In another application of the business judgment rule, a Delaware Chancery Court cited the rule to dismiss claims against directors who chose not to put their company into bankruptcy.[76] As one commentator noted, ultimately "[d]ecisions such as *Citigroup* remind us that when the prerequisites of the business judgment rule are satisfied, the Delaware courts will not second-guess business decisions that in retrospect could have been decided differently."[77]

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[70] *Id.* (internal quotations and brackets omitted).

[71] Gantler v. Stephens, 965 A.2d 695, 706 (Del. 2009).

[72] *In re* Caremark Int'l Inc., 698 A.2d 959, 967–69 (Del. Ch. 1996) (footnotes omitted).

[73] *In re* Citigroup, Inc., 964 A.2d 106, 124 (Del. Ch. 2009) ("The standard of director liability under the business judgment rule is predicated upon concepts of gross negligence.") (internal quotations omitted).

[74] *See Gantler*, 965 A.2d at 706.

[75] *Id.*

[76] *See* Binks v. DSL.net, Inc., No. 2823-VCN, 2010 WL 1713629 (Del. Ch. Apr. 29, 2010).

[77] Kevin F. Brady and Francis Pileggi, *Recent Delaware Corporate and Commercial Decisions*, 6 N.Y.U. J. LAW & BUS. 421 (Spring 2010).

Irrespective of the business judgment rule, this "duty" of good faith and fair dealing is unique under Delaware in that it may not be waived in corporate charter documents.

d. Imputation of "General Fiduciary Duties"[78]

Delaware law states that in the absence of an agreement to the contrary, a "manager of an LLC owes the **traditional fiduciary duties** of loyalty and care to the members of the LLC."[79] In applying the "traditional fiduciary duties" to managers of LLCs, Delaware courts apply the same specific standards applied to corporate directors.[80]

Delaware law similarly imputes the "fiduciary duties of care and loyalty" to members and officers of Delaware corporations.[81] Both officers and directors of corporations owe these "identical" traditional fiduciary duties to their corporations.[82]

Delaware courts apply the "default" fiduciary duties even in the absence of statutory mandates. In fact, the "Delaware LLC Act is silent on what fiduciary duties members of an LLC owe each other," which Delaware courts interpret to mean "the matter [is] to be developed by the common law."[83] Moreover, "in the absence of developed LLC case law," Delaware courts "often [decide] cases by looking to analogous provisions in limited partnership law."[84] The Delaware LLC cases have to date, "in the absence of provisions in the LLC agreement explicitly disclaiming the applicability of default principles of fiduciary duty," treated LLC members as owing each other the traditional fiduciary duties that directors owe a corporation.[85]

These same "traditional fiduciary duties" are also applied to limited partnerships. In the limited partnership context, Delaware courts have again established that "absent a contrary provision in the partnership agreement, the general partner of a Delaware limited partnership owes the traditional fiduciary duties of loyalty and care to the Partnership and its partners."[86] Moreover, even "those affiliates of a general partner who exercise control over

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[78] The authors wish to express their gratitude to Walker C. Friedman and Leza Kerr of Friedman, Suder & Cooke, P.C. for their substantial contributions and assistance with this Section.

[79] Bay Ctr. Apartments Owners, LLC v. Emery Bay PKI, LLC, C.A. No. 3658-VCS, 2009 WL 1124451, at *8 (Del. Ch. April 20, 2009) (emphasis added).

[80] *See, e.g.*, Metro Commc'ns Corp. BVI v. Advanced MobileComm Tech., 854 A.2d 121, 155–56 (Del. Ch. 2004) ("[I]t is unsurprising that our law of fiduciary duty has evolved to the point in which there are specific standards that govern the liability of entity fiduciaries, such as managers of LLCs or more commonly corporate directors, for disclosures or non-disclosures to entity owners"); VGS, Inc. v. Castiel, C.A. No. 17995, 2000 WL 1277372 at *4 (Del. Ch. Aug. 31, 2000), *aff'd* 781 A.2d 696 (Del. 2001)) (two malfeasant managers "each owed a duty of loyalty to the LLC, its investors and Castiel, their fellow manager and majority member").

[81] *See* Gantler v. Stephens, 965 A.2d 695, 708–09 (Del. 2009).

[82] *Id.* at 709, n.36.

[83] *Bay Ctr. Apartments Owners*, 2009 WL 1124451, at *8, n.33.

[84] *Id.* at *9.

[85] *Id.* (quoting Douzinas v. Am. Bureau of Shipping, Inc., 888 A.2d 1146, 1149–50 (Del. Ch. 2006); *Metro Commc'n Corp. BVI*, 854 A.2d at 153; *VGS, Inc.*, 2000 WL 1277372, at *4–5.

[86] Gotham Partners, LP v. Hallwood Realty Partners, LP, 2000 WL 1476663, at *10 (Del. Ch. Sept. 27, 2000); *see also* Martin I. Lubaroff & Paul M. Altman, *Delaware Limited Partnerships* § 11.2.2 at 11-5 to 11-7 (2003).

the partnership's property may find themselves owing fiduciary duties to both the partnership and its limited partners."[87]

In yet another application of the traditional fiduciary duties, "an attorney-in-fact generally assumes the obligations of a fiduciary."[88] This fiduciary relationship, comparable to that created in a formal trust, "subjects the holder of a power of attorney to a **duty of loyalty** obligating her to act in the best interests of her principal in exercising such power."[89]

While the vast majority of Delaware case law has consistently applied these default duties in the absence of explicit contractual language, the Chief Justice of the Supreme Court of Delaware authored an article that harshly criticized default fiduciary duties in the LLC context. Chief Justice Steele does not embrace what he calls "the commonly accepted puritanical default fiduciary duty norm," but argues that courts should simply look to the entity's formation documents and only apply the duties found therein.[90] Chief Justice Steele calls the imputation of default fiduciary duties "Byzantine," and notes that a single case, *Fisk Ventures LLC v. Segal*, has questioned whether default fiduciary duties really do exist as a matter of common law.[91]

The *Fisk* court examined claims made by a principal against the members of his failed LLC. The principal claimed that the members of the LLC breached their fiduciary duties when the board came to a stalemate. The court ultimately dismissed the principal's claims under Federal Rule of Civil Procedure 12(b)(6) because he failed to show that the members owed the LLC *any* fiduciary duties.[92] The court reasoned that "[i]n the context of limited liability companies, which are creatures not of the state but of contract, those duties or obligations must be found in the LLC Agreement or some other contract."[93] Because the plaintiff failed to "allege breaches of duties found" in the LLC Agreement, the court concluded that it "must dismiss" the plaintiff's claims.[94]

The *Fisk* case represents a departure from the common application of "default" fiduciary duties, and the Steele article advocates for the removal of default duties in the LLC context.

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[87] *Bay Ctr. Apartments Owners*, 2009 WL 1124451, at *9.

[88] Coleman v. Newborn, 948 A.2d 422, 429 (Del. Ch. 2007).

[89] *Id.* (emphasis added). Texas courts sometimes apply the same "default" or "traditional" fiduciary duties borrowed from Delaware. For example, Texas law imputes the same common law fiduciary duties as Delaware in the context of attorneys-in-fact, holding that "[A] power of attorney creates an agency relationship, which is a fiduciary relationship as a matter of law." Vogt v. Warnock, 107 S.W.3d 778, 782 (Tex. App.—El Paso 2003, pet. denied); *see also* Plummer v. Estate of Plummer, 51 S.W.3d 840, 842 (Tex. App.—Texarkana 2001, pet. denied); Sassen v. Tanglegrove Townhouse Condominium Ass'n, 877 S.W.2d 489, 492 (Tex. App.—Texarkana 1994, writ denied). A fiduciary in this context "owes her principal a high duty of good faith, fair dealing, honest performance, and strict accountability." *Id.*

[90] Myron T. Steele, *Freedom of Contract and Default Contractual Duties in Delaware Limited Partnerships and Limited Liability Companies*, 46 AM. BUS. L. J. 221, 222 (2009).

[91] *Id.* (citing Fisk Ventures, LLC v. Segal, No. 3017-CC, 2008 Del. Ch. LEXIS 158, 2008 WL 1961156 (Del. Ch. May 7, 2008)).

[92] *Fisk*, 2008 Del. Ch. LEXIS 158, at *28.

[93] *Id.*

[94] *Id.* at *29.

However, another recently published article argues against the removal of default fiduciary duties, contending that allowing contractual waiver of fiduciary duties is, at a minimum, bad policy, and perhaps unconstitutional.[95]

3. Waiver of Fiduciary Duties Under Delaware Law

Delaware law permits exculpatory provisions to absolve corporate directors of all monetary breach of fiduciary duty claims except those involving bad faith, intentional misconduct, or the duty of loyalty.[96] Thus an exculpatory provision permissibly eliminates all liability for breaches of the duty of care, including grossly negligent acts.[97]

Under Section 102(b)(7) of the Delaware Code, a certificate of incorporation may contain a provision limiting or eliminating personal financial liability of a director to the corporation or its stockholders.[98] This safe harbor, however, does not limit the duty owed by directors to the corporation or its stockholders and transactions undertaken by the board remain subject to remedies such as injunction and rescission.[99]

As noted, fiduciary duties in Delaware exist by default in the limited liability company context "in the absence of a contrary provision in the LLC agreement."[100] The Chancery Court's statement derives from Section 18-1101 of the Delaware Limited Liability Company Act:

> (c) To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement, the member's or manager's or other person's duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement; provided, that the limited liability company

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[95] *See* Lyman Johnson, *Delaware's Non-Waivable Duties*, 91 BOSTON U. L. REV. 701, 702–03 (2011).

[96] Del. Code tit. 8, § 102(b)(7) (2011).

[97] AIG, Inc. v. Greenburg, 965 A.2d 763, 795 n.113 (Del. Ch. 2009) ("The AIG certificate of incorporation has a [section] 102(b)(7) clause that insulates AIG's directors from liability for monetary damages for any harm flowing from their gross negligence."); Wayne County Employees' Ret. v. Corti, 2009 WL 2219260, at *19 (Del. Ch. July 24, 2009) ("[T]he exculpatory provision in Activision's certificate even eliminates the personal liability of the Director Defendants for monetary damages for breaches of the duty of care, including actions that constitute gross negligence.").

[98] DEL. CODE ANN. tit. 8, § 102(b)(7).

> [Articles of incorporation may include a] provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as director, provided that such provision shall not eliminate or limit the liability of a director: (i) for any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of the law; (iii) under [section] 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit.

[99] Balotti & Finkelstein, *supra* note 51, § 4.34, at 4-240.

[100] Bay Ctr. Apartments Owners, LLC v. Emery Bay PKI, LLC, C.A. No. 3658-VCS, 2009 WL 1124451, at *8 & n.33 (Del. Ch. April 20, 2009).

> agreement may not eliminate the implied contractual covenant of good faith and fair dealing.
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>
> (e) A limited liability company agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a member, manager or other person to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement; provided, that a limited liability company agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.[101]

A Delaware LLC that wishes to restrict or eliminate liability for fiduciary duties thus has the statutory power to do so—but only in a clearly expressed way: "the drafters of chartering documents **must make their intent to eliminate fiduciary duties plain and unambiguous."**[102] Thus, under Delaware law, an LLC agreement may eliminate certain fiduciary duties, but for such elimination to be effective, the company agreement must do so plainly and unambiguously.

The Delaware Legislature's allowance for waiver of fiduciary duties in the LLC context led to a boom in new LLC formations in Delaware since the Limited Liability Company Act's amendment in 2004. One commentator notes that "[a]s evidence of the Delaware limited liability company's . . . prowess, the Delaware Secretary of State reports that nearly 112,000 new LLCs were formed in 2007, compared to just 43,000 new formations in 2001."[103]

In addition many Delaware corporations have an exculpatory provision in their corporate charters absolving corporate directors of liability for suits brought on behalf of the corporation for violations of the duty of care.[104] A proper exculpatory clause that complies with section 102(b)(7) prevents suits on behalf of the company premised on gross negligence or the duty of care.[105] Section 102(b)(7), however, does not permit exculpatory provisions for "among other things, breaches of the duty of loyalty or actions or omissions not in good faith or that involve

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[101] 6 DEL. C. § 18-1101 (2013) (emphasis added).

[102] *Bay Ctr. Apartments Owner, LLC*, 2009 WL 1124451, at *9 (emphasis added); *see also* Miller v. Am. Real Estate Partners, LP, 2001 WL 1045643, at *8 (Del. Ch. Sept. 6, 2001) ("[D]efault principles of fiduciary duty will apply unless a partnership agreement plainly provides otherwise."); Sonet v. Timber Co., LP, 722 A.2d 319, 322 (Del. Ch. 1998); *cf* Kahn v. Icahn, 1998 WL 832629, at *3 (Del.Ch. Nov.12, 1998) (holding that limited partners could not bring a duty of loyalty claim where the partnership agreement contained "clear and unambiguous modifications of fiduciary duties").

[103] Steele, *supra* note 90, at 222. Chief Justice Steele notes that over this same time period, the perannum number of new corporations formed in Delaware has decreased. *Id.* at n.2.

[104] *See* DEL. CODE ANN. tit. 8, § 102(b)(7) (2013).

[105] *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 47 n.37, 67 (Del. 2006).

intentional misconduct or a knowing violation of the law."[106] Because many corporations have a section 102(b)(7) exculpatory clause, plaintiffs often attempt to turn duty of care claims into bad faith claims that are not precluded by an exculpatory provision. The Delaware Supreme Court has concluded that good faith violations encompass similar conduct to duty of care violations though they are more culpable.

> [T]he universe of fiduciary misconduct is not limited to either disloyalty in the classical sense ([i.e.], preferring the adverse self-interest of the fiduciary or of a related person to the interest of the corporation) or gross negligence. Cases have arisen where corporate directors have no conflicting self-interest in a decision, yet engage in a misconduct that is more culpable than simple inattention or failure to be informed of all the facts material to the decision. To protect the interests of the corporation and its shareholders, fiduciary conduct of this kind, which does not involve disloyalty (as traditionally defined) but is qualitatively more culpable than gross negligence, should be proscribed. A vehicle is needed to address such violations doctrinally, and that doctrinal vehicle is the duty to act in good faith.[107]

Moreover Delaware entities may not waive implied contractual covenants of good faith and fair dealing, no matter how explicit the corporate charters.[108] In the context of choice of law provisions being interpreted by Texas courts, a "choice of law provision in a contract that applies only to the interpretation and enforcement of the contract does not govern tort claims."[109]

Adding to the clear weight of Delaware authority imposing such individual fiduciary duties absent a clear intent to alter or abolish them, the Delaware Chancery Court very recently reaffirmed that proposition in *Kelly v. Blum*.[110] The court in *Kelly v. Blum* held again that "in the absence of a contrary provision in the LLC agreement," LLC managers and members owe "traditional fiduciary duties of loyalty and care" to each other and to the company.[111]

Whether waivable or not, traditional fiduciary duty concepts also arise in the context of minority shareholder rights, which are discussed in the section, "Minority Shareholder Oppression."

III. INTERNAL AFFAIRS DOCTRINE

Texas recognizes the internal affairs doctrine as a conflicts of law principle through both statute and common law. Delaware applies the internal affairs doctrine as both a conflicts of

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[106] *In re* Citigroup Inc. S'holder Derivative Litig., 964 A.2d 106, 124 (Del. Ch. 2009).

[107] *In re Walt Disney Co.*, 906 A.2d at 66.

[108] *See* 6 DEL. C. § 18-1101 (2013).

[109] Red Roof Inns, Inc. v. Murat Holdings, LLC, 223 S.W.3d 676, 684 (Tex. App.—Dallas 2007, pet. denied) (citing Stier v. Reading & Bates Corp., 992 S.W.2d 423, 433 (Tex. 1999)).

[110] Kelly v. Blum, 2010 WL 629850 at *10–11 (Del. Ch. Feb. 24, 2010).

[111] *Id.* at *10, n.69.

law principle and a constitutional mandate, but does not require it by specific statute. Both jurisdictions cite the same United States Supreme Court cases to explain the doctrine's rationale.

A. Internal Affairs Doctrine in Texas

Texas law dictates that any claims involving a foreign entity's internal affairs will be governed by the state in which the entity was incorporated.[112] The internal affairs doctrine is based on the principle that "only one State should have the authority to regulate a corporation's internal affairs."[113] The "internal affairs of an entity include: the rights, powers, and duties of its governing authority, governing persons, officers, owners, and members" as well as "matters relating to its membership or ownership interests."[114]

To apply the internal affairs doctrine in Texas, "a preliminary motion must be filed asking the court to apply another state's laws."[115]

B. Internal Affairs Doctrine in Delaware

Delaware enforces the internal affairs doctrine as both a conflict of laws principle and a constitutional mandate.[116] The internal affairs doctrine is "a long-standing choice of law principle which recognizes that only one state should have the authority to regulate a corporation's internal affairs – the state of incorporation."[117] Internal affairs include "those matters that pertain to the relationships among or between the corporation and its officers, directors, and shareholders."[118]

Delaware also considers the internal affairs doctrine to be a constitutional mandate "except in the rarest of situations."[119] Pursuant to the Fourteenth Amendment Due Process

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[112] TEX. BUS. ORGS. CODE ANN. § 1.102 (West 2006) (when an entity is formed through a foreign governmental body, "the law of the state or other jurisdiction in which that foreign governmental authority is located governs the formation and internal affairs of the entity"). The internal affairs doctrine was governed by Article 1528(n) of the Texas Limited Liability Company Act and Article 8.02(A) of the Texas Business Corporation Act before being repealed and replaced by the Texas Business Organizations Code in 2006.

[113] State Farm Mut. Auto. Ins. Co. v. Lopez, 156 S.W.3d 550, 557 n.7 (Tex. 2004) (citing Edgar v. MITE Corp., 457 U.S. 624, 645 (1982)).

[114] TEX. BUS. ORGS. CODE ANN. § 1.105 (West 2006).

[115] Progressive Child Care Sys., Inc. v. Kids 'R' Kids Int'l, Inc., 2-07-127-CV, 2008 Tex. App. LEXIS 8416, 2008 WL 4831339, at *2 (Tex. App.—Fort Worth Nov. 6, 2008, pet. denied); *see also* TEX. R. EVID. 202 (stating that on a party's motion, courts shall take notice of another state's laws); Burlington Northern & Santa Fe Ry. v. Gunderson, Inc., 235 S.W.3d 287, 290 (Tex. App.—Fort Worth 2007, pet. withdrawn) ("A preliminary motion is necessary to assure the application of the law of another jurisdiction, and absent a motion by a party, Texas law may be applied to a dispute.").

[116] McDermott Inc. v. Lewis, 531 A.2d 206, 215 (Del. 1987).

[117] Vantagepoint Venture Partners v. Examen, Inc., 871 A.2d 1108, 1112 (Del. 2005) (citing *Edgar*, 457 U.S. at 645).

[118] *Vantagepoint Venture Partners*, 871 A.2d at 1113 (quoting *McDermott Inc.*, 531 A.2d at 214).

[119] *Id.* The only example the Delaware Supreme Court gives of a rare circumstance when the internal affairs doctrine would not be constitutionally mandated is where "the law of the state of incorporation is inconsistent with a

Clause, directors and officers of corporations have a right to know the law that will be applied to their actions and stockholders are entitled to know by what standards of accountability they may hold those managing the internal affairs.[120] "By providing certainty and predictability, the internal affairs doctrine protects the justified expectations of the parties with interests in the corporation."[121] Additionally, the Commerce Clause dictates that a state "has no interest in regulating the internal affairs of foreign corporations."[122]

C. Internal Affairs Doctrine and Fiduciary Duty

An entity's internal affairs have been widely held to include claims involving fiduciary duties.[123]

Texas courts also apply the internal affairs to fiduciary duty claims based on a *defendant's* status as a shareholder. In Texas, "the internal affairs of the foreign corporation, including but not limited to the rights, powers, and duties of its board of directors and shareholders and matters relating to its shares, are governed by the laws of the jurisdiction of incorporation."[124]

D. Summary of Internal Affairs Doctrine

Texas and Delaware use the same definition of the internal affairs doctrine: the law of the state of an entity's incorporation shall govern a corporation's internal affairs—including in the context of fiduciary duty liability. Both states also rely on the doctrine as a conflicts of law principle. However, where Texas requires the doctrine's application through a state statute, Delaware relies on common law and a constitutional mandate.

IV. MINORITY SHAREHOLDER OPPRESSION

A. Introduction

As will be seen, Texas and Delaware courts take radically different approaches to dealing with conduct that might be described as "minority shareholder oppression." Texas has a

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national policy on foreign or interstate commerce." *Id.* (quoting CTS Corp. v. Dynamics, 457 U.S. 69, 90 (1987)).

120 *Id.* (citing *McDermott Inc.*, 531 A.2d at 216–17).

121 *Id.*

122 *Id.* (quoting *Edgar*, 457 U.S. at 645–46).

123 *E.g.*, *In re* World Health Alternatives, Inc., 385 B.R. 576, 589 (Bankr. D. Del. April 9, 2008) ("A breach of fiduciary duty claim involves the internal affair of a corporation." (citation omitted)); *In re Circle Y of Yoakum, Texas,* 354 B.R. 349, 359 (Bankr. D. Del. 2006) (same); LaSala v. Bodier et Cie, 519 F. 3d 121, 131 n. 13 (3rd Cir. 2008) ("The parties agree that Delaware law applies to the breach-of-fiduciary-duty counts. This is clearly correct, as the claims involve the corporation's internal affairs, and the state of incorporation is Delaware."); Ayres v. AG Processing, Inc., 345 F. Supp. 2d 1200, 1206 (D. Kan. 2004) (holding that minority LLC members' claim for breach of fiduciary duty against majority LLC member and LLC's managers involved "internal affairs" and thus law of state where LLC was organized would apply).

124 Hollis v. Hill, 232 F.3d 460, 465 (5th Cir. 2000) (quoting TEX. BUS. CORP. ACT ANN. art. 8.02(A); Enigma Holdings, Inc. v. Gemplus Int'l, S.A., 3: 05-CV-1168-B ECF, 2006 WL 2859369 at *7–8; *see also* Sommers Drug Stores Co. Emp. Profit Sharing Trust v. Corrigan, 883 F.2d 345, 354 (5th Cir. 1989).

receivership statute that mentions, but does not define, "shareholder oppression" as a ground for receivership.[125] Some Texas courts of appeals have applied this statute outside of the receivership context to create a vague cause of action with poorly-defined parameters sometimes referred to as "shareholder oppression." Delaware has no similar statute, and has developed a limited set of remedies (often mirroring statutory appraisal rights) to apply in circumstances that are described as having oppressive characteristics. The need for these remedies often arises in the context of "squeeze-out" mergers and "freeze-outs." While sometimes invoking Delaware courts' "equitable" powers and equitable doctrines, analyzed as a group, these cases result in a more carefully defined category of "minority shareholder oppression," which is applied in more limited circumstances than Texas lower courts' use of the doctrine.

The Texas courts have characterized oppression broadly, leading to imprecise boundaries of what constitutes oppressive actions requiring remedy. Notably, in Texas, "[t]here is no set standard for determining whether shareholder oppression has occurred."[126] Instead, courts "must examine the facts as a whole and determine whether the corporation's conduct has deprived a minority shareholder of the shareholders' reasonable expectations as an equity holder of the corporation."[127] This section of the paper will first look at the vague and ill-defined parameters of the Texas "cause of action," and then discuss three standards by which Delaware courts evaluate oppressive action in the shareholder context. It will briefly discuss several Delaware cases that touch on shareholder "oppression," including several interesting cases protecting the *majority* shareholder(s) from oppression.

B. Shareholder Oppression Law in Texas[128]

Texas Courts have rarely allowed relief for shareholder oppression. Only seven cases since the statute's adoption over fifty years ago have allowed narrowly limited relief for oppression.[129] Eleven held there was *no* oppression.[130] Five merely reversed dispositive

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[125] TEX. BUS. CORP. ACT ANN. art. 7.05(A)(1)(c) (recodified at TEX. BUS. ORGS. CODE ANN. § 11.404 (West 2010)).

[126] *In re White*, 429 B.R. 201, 213 (Bankr. S.D. Tex 2010).

[127] *Id.*

[128] Special thanks to David Harper and Michelle Jacobs of Haynes and Boone, LLP for their substantial contribution to this Section from their recent publication *Corporate Fiduciary Duties and Shareholder Oppression in Texas*, Advanced In-House Counsel Course, State Bar of Texas, July 2010.

[129] *See* Cardiac Perfusion Servs., Inc. v. Hughes, No. 05-10-00286-CV, at *3–5 (Tex. App.—Dallas July 26, 2012); Ritchie v. Rupe, 339 S.W.3d 275, 281 (Tex. App.—Dallas 2011, pet. filed) (FMV of stock); Devji v. Keller, No. 03-99-436-CV, 2000 Tex. App. LEXIS 8491, at *14 (Tex. App.—Austin Dec. 21, 2000, no pet.) ($39,000 capital contribution return); Advance Marine, Inc. v. Kelley, No. 01-90-645-CV, 1991 Tex. App. LEXIS 1614, at *2 (Tex. App.—Houston [1st Dist.] June 27, 1991, no writ) (buyout); Davis v. Sheerin, 754 S.W.2d 375, 383 (Tex. App.—Houston [1st Dist.] 1988, writ denied) (buyout); *In re White*, 429 B.R. at 214 (bonus if any dividends *or* buyout); *In re Rosenbaum*, No. 08-43029, 2010 Bankr. LEXIS 1509, at *19–20 (Bankr. E.D. Tex. May 7, 2010) (return of $325,000 stock purchase price); *see also Patton*, 279 S.W.2d at 854 (pre-statutory case with dividend relief).

[130] *See* ARGO Data Resource Corp. v. Shagrithaya, 380 S.W.3d 249 (Tex. App.—Dallas 2012, pet. filed); Allen v. Devon Energy Holdings, LLC, 367 S.W.3d 355, 398–99 (Tex. App.—Hous. [1st Dist.] 2012); Guerra v. Guerra, No. 04-10-00271-CV, WL 3715051, at *11 (Tex. App.—San Antonio August 24, 2011); Art v. Schmart Eng'g, Inc., No. 13-02-00621-CV, 2008 Tex. App. LEXIS 7540 (Tex. App.—Corpus Christi Oct. 9, 2008, no pet.);

motions.[131] And twelve mentioned oppression but did not address it for a variety of reasons.[132]

The seven cases that allowed relief did so only because extreme circumstances justified intervention with corporate governance, e.g., (1) a refusal to recognize the minority's stock ownership at all;[133] (2) disguised dividends or other asset diversions intended to exclude the plaintiff shareholder from proportionate profit sharing;[134] (3) capital calls or contributions solicited from the minority shareholder while majority shareholders transferred assets to themselves, usurped corporate opportunities, or purposefully and actually rendered the minority's shares worthless;[135] and (4) a wrongful interference with the sale of stock to a third party.[136]

The Texas Supreme Court has yet to recognize a cause of action for shareholder oppression or to define its parameters.[137] While a number of Texas courts of appeals have also never recognized the cause of action, some have upheld claims for shareholder oppression or at least recognized it as a viable claim. But these courts' justifications for recognizing a broad shareholder oppression claim are questionable, because they rely on: (1) a Texas Supreme Court case that never acknowledged shareholder oppression as a valid claim; (2) a Texas

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Gibney v. Culver, No. 13-06-112-CV, 2008 Tex. App. LEXIS 2954, at *57–58 (Tex. App.—Corpus Christi Apr. 10, 2008, pet. denied); Allchin v. Chemic, Inc., No. 14-01-0043-CV, 2002 Tex. App. LEXIS 5125, at *25 (Tex. App.—Houston [14th Dist.] July 18, 2002, no pet.); Willis v. Bydalek, 997 S.W.2d 798, 801 (Tex. App.—Houston [1st Dist.] 1999, pet. denied); Pinnacle Data, Inc. v. Gillen, 104 S.W.3d 188 (Tex. App.—Texarkana 2003, no pet.); Christians v. Stafford, No. 14-99-0038-CV, 2000 Tex. App. LEXIS 6423 (Tex. App.—Houston [14th Dist.] Oct. 26, 2000, no pet.); Tex. Coll. Bowl, Inc. v. Phillips, 408 S.W.2d 537 (Tex. Civ. App.—Texarkana 1966, no writ).

[131] Redmon v. Griffith, 202 S.W.3d 225 (Tex. App.—Tyler 2006, pet. denied) (reversing summary judgment); Cotten v. Weatherford Bancshares, Inc., 187 S.W.3d 687, 707–08 (Tex. App.—Fort Worth 2006, pet. denied) (reversing directed verdict); Coates v. Parnassus Sys., Inc., No. 03-01-00549-CV, 2002 Tex. App. LEXIS 2545 (Tex. App.—Austin 2002, no pet.) (reversing summary judgment); Joseph v. Koshy, No. 01-98-01432-CV, 2000 Tex. App. LEXIS 810 (Tex. App.—Houston [1st Dist.] Feb. 3, 2000, no pet.) (reversing summary judgment based on failure to adequately address claims in traditional motion); Bulacher v. Enowa, LLC, 2010 U.S. Dist. LEXIS 27784, at *4 (N.D. Tex. 2010) (reversing grant of motion to dismiss).

[132] Swett v. At Sign, Inc., No. 02-08-315-CV, 2009 Tex. App. LEXIS 3579 (Tex. App.—Fort Worth May 21, 2009, no pet.); Flores Star Cab Coop. Ass'n, 2008 Tex. App. LEXIS 6582 (Tex. App.—Amarillo Aug. 28, 2008, pet. denied); Warren v. Warren Equip. Co., 189 S.W.3d 324 (Tex. App.—Eastland 2006, no pet.); Boondoggles Corp. v. Yancey, 2006 Tex. App. LEXIS 6896 (Tex. App.—Houston [1st Dist.] Aug. 3, 2006, no pet.); Gonzalez v. Greyhound Lines, Inc., 181 S.W.3d 386 (Tex. App.—El Paso 2005, pet. denied); *Willis v. Donnelly*, 118 S.W.3d 10 (Tex. App.—Houston [14th Dist.] 2003), *rev'd*, 199 S.W.3d 262 (Tex. 2006); *In re* Profanchik & Conversant Tech., Inc., 31 S.W.3d 381 (Tex. App.—Corpus Christi 2000, orig. proceeding); Hoggett v. Brown, 971 S.W.2d 472 (Tex. App.—Houston [14th Dist.] 1997, pet. denied); Debord v. Circle Y of Yoakum, 951 S.W.2d 127 (Tex. App.—Corpus Christi 1997), *rev'd*, 967 S.W.2d 352 (Tex. 1998); Alexander v. Sturkie, 909 S.W.2d 166 (Tex. App.—Houston [14th. Dist.] 1995, writ denied); Faour v. Faour, 789 S.W.2d 620 (Tex. App.—Texarkana 1990, writ denied); Duncan v. Lichtenberger, 671 S.W.2d 948 (Tex. App.—Fort Worth 1984, writ ref'd n.r.e.).

[133] *Patton*, 279 S.W.2d at 854; *Davis*, 754 S.W.2d at 383; *In re White*, 429 B.R. at 214.

[134] *Kelley*, 1991 Tex. App. LEXIS 1614, at *2; *In re White*, 429 B.R. at 214.

[135] *Devji*, 2000 Tex. App. LEXIS 8491, at *14; *In re White*, 429 B.R. at 214; *Rosenbaum*, 2010 Bankr. LEXIS 1509, at *19–20.

[136] Ritchie v. Rupe, 339 S.W.3d 275, 304–05 (Tex. App.—Dallas 2011, pet. filed).

[137] As discussed in the subsequent section, the Texas Supreme Court in Patton v. Nicholas, 279 S.W.2d 848, 849, 859 (Tex. 1955) did not describe the minority shareholder's claim as one for "oppression," did not define any elements of the claim, and did not explicitly recognize a claim for "shareholder oppression."

receivership statute that allows relief from oppression only in limited and extreme circumstances; and (3) a Texas appellate court case that relied on the previous two faulty grounds and on inapplicable case law from other jurisdictions. Given this weak foundation, when the Texas Supreme Court confronts the issue in *Ritchie v. Rupe*, it is uncertain whether it will recognize a claim for shareholder oppression beyond the purview of the receivership statute. Because some Texas courts of appeals have recognized the claim, however, it is necessary to understand its scope and application.

1. Existence of the Cause of Action

Two key cases and a receivership statute have laid the foundation for some courts of appeals to recognize a cause of action for shareholder oppression. The following is a summary of these sources and a discussion of why each fails to support a claim for shareholder oppression.

a. Patton v. Nicholas: Laying the Groundwork for a Shareholder Oppression Claim

In *Patton v. Nicholas*, the Texas Supreme Court reversed an order of liquidation in a suit brought by a minority shareholder for certain domineering conduct by the defendant, who was the president, director, and majority shareholder of the corporation.[138]

The defendant, in a malicious effort to prevent the minority shareholders from recognizing any returns on their ownership, effectively forced the resignation of the minority shareholders from the company's employ and also prevented dividends from being issued.[139] In addition, the defendant sought to "otherwise lower[] . . . the value of the stock" of the minority shareholders and to dominate the board of directors.[140]

Evaluating the defendant's conduct, the court determined that the defendant's domination of the board, by itself, was not problematic because, as "the founder of the business, president, owner of a clear majority of the stock and the only substantial stockholder on a board composed largely of employees," the defendant "could hardly avoid imposing his personal views on the other members, whatever his intentions."[141] But the defendant's conduct, viewed as a whole, convinced the court to rule in favor of the minority shareholders:

> [C]oupling all the circumstances indicating the petitioner's intent to eliminate the respondents from every connection with the business, and at an unfair sacrifice on their part, with the fact that no dividends were paid in the face of an accumulation of surplus . . . at the rate of almost 10% per annum, the findings of malicious suppression of dividends must be sustained.[142]

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138 279 S.W.2d 848, 849, 859 (Tex. 1955).

139 *Id.* at 852–53.

140 *Id.* at 853.

141 *Id.*

142 *Id.* at 854.

Although the court determined that liquidation might be appropriate in certain "extreme" cases like the one before it, the court did not find it appropriate to liquidate the corporation.[143] Instead, it granted injunctive relief to the minority shareholder, requiring the defendant to issue reasonable present and future dividends.[144]

The court never described the minority shareholder's claim as one for "oppression," nor did it define any elements of the claim. Thus, while *Patton* provided relief for extreme conduct that denied even the existence of the minority shareholders, it did not explicitly recognize a claim for "shareholder oppression." Likewise, the court also did not recognize a cause of action for malicious suppression of dividends. It simply found that, under the extreme facts of the case, relief was justified, in part, based on the adopted—but not yet effective—receivership statute.

b. Texas Receivership Statute: Legislative Foundation for Shareholder Oppression Claim

The Business Organizations Code authorizes a rehabilitative receivership if an owner of a domestic entity establishes that "the actions of the governing persons of the entity are *illegal, oppressive, or fraudulent*."[145] "[G]overning persons" includes the board of directors of a corporation; it "does not include an officer who is acting in the capacity of an officer."[146] Relief is allowed only if: (1) necessary to conserve the property and business of the corporation and to avoid damage to interested parties; and (2) all other available legal and equitable remedies are inadequate.[147] Additionally, the statute provides that any relief awarded under the statute be "terminated immediately" when the condition necessitating the relief ends.[148]

The rehabilitative statute contemplates relief if (1) wrongdoing ("illegal, oppressive[,] or fraudulent" conduct); (2) at the board level; (3) affects the well-being of the corporate entity and damages an interested party for which; (4) there continues to be a need for the relief; and (5) there is no other adequate remedy at law or in equity.[149] Unfortunately, the statute does not define "oppressive" conduct.

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[143] *Id.* at 856–57.

[144] *Id.* at 857.

[145] TEX. BUS. ORGS. CODE ANN. § 11.404(a)(1)(C) (West Supp. 2010) (emphasis added) (formerly TEX. BUS. CORP. ACT ANN. Art. 7.05 (West Supp. 2002)). Article 7.05 was recodified into Texas Business Organizations Code § 11.404, mandatorily effective in 2010. Although not using the phrase "governing persons," the no-longer-effective Business Corporations Act contained similar language that rested on corporate level inquiries of insolvency, deadlock, illegality or waste, the "acts of the directors or those in control of the corporation," conservation of corporate assets and affairs, lack of other adequate remedy, and termination of any receivership upon removal of the condition. TEX. BUS. CORP. ACT art. 7.05 (West 2009). "Those in control of the corporation" under the meaning and purpose of the statute is the Board of Directors. *Id.* The expired statute thus carried the same requirements as the statute that now applies.

[146] *Id.* § 1.002(35).

[147] *Id.* § 11.404(b).

[148] *Id.* § 11.404(c).

[149] TEX. BUS. ORGS. CODE § 11.404; TEX. BUS. CORP. ACT art. 7.05 (West 2009).

Since *Patton* referred to the precursor to this statute to justify the relief ordered in that case, courts that have recognized shareholder oppression treat this statute as the legislative foundation for a "shareholder oppression" claim.

The recent Dallas Court of Appeals case, *Richie v. Rupe,*[150] made clear that shareholder oppression claims are statutory in nature.[151]

c. Davis v. Sheerin: Texas Courts' First True Attempt at Defining Oppression

In *Davis v. Sheerin*, the plaintiff sued the defendants for their oppressive conduct toward him as a minority shareholder.[152] The defendants claimed that the trial court improperly ordered a "buy-out" of the minority shareholder's interest.[153] In evaluating this claim, the court looked to *Patton*, the receivership statute, and case law from other jurisdictions.[154]

The court upheld the ordered "buy-out," despite recognizing that the Texas receivership statute "does not expressly provide for the remedy of a 'buy-out' for an aggrieved minority shareholder."[155] The court determined that because the receivership statute allowed the appointment of a liquidating receiver for oppressive conduct, a court could always impose a less drastic remedy.[156] Thus, because a buyout is less burdensome than a forced liquidation, it is within a court's equitable powers.[157] The *Davis* court further acknowledged that the receivership statute "does not define oppressive conduct."[158] The court then crafted its own standard for oppression based on case law from other jurisdictions.[159] These out-of-state cases are of minimal precedential value in Texas, however, because they impose a fiduciary relationship between close corporation shareholders.[160] But Texas recognizes no such duty. Thus, relying on shaky legal grounds, *Davis* recognized shareholder oppression as a cause of action greater in scope than that explicitly authorized by the receivership statute or Texas case law.

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[150] Ritchie v. Rupe, 339 S.W.3d 275 (Tex. App.—Dallas 2011, pet. filed).

[151] *Id.* at 289 ("Statutes like article 7.05 providing remedies for oppression rarely define the term."); *see also* Davis v. Sheerin, 754 S.W.2d 375, 381, 383 (Tex. App.—Houston [1st Dist.] 1988, writ denied) (article 7.05 "provides a cause of action based on oppressive conduct"); *In re White*, 429 B.R. 201, 214 (Bankr. S.D. Tex. 2010) (the Business Organizations Code "informs" when a court should impose equitable relief); Patton v. Nicholas, 279 S.W.2d 848, 851–52 (Tex. 1955) (adopted-but-not-yet effective article 7.05 represents "approach" to extreme oppression complaint).

[152] *Davis*, 754 S.W.2d at 377.

[153] *Id.* at 378.

[154] *See id.* at 378–80, 83–84.

[155] *Id.* at 378.

[156] *In re White*, 429 B.R. at 215 (citing *Davis*, 754 S.W.2d at 384).

[157] *Id.*

[158] *Davis*, 754 S.W.2d at 381.

[159] *See id.*

[160] *See id.* (citing McCauley v. Tom McMauley & Son, Inc., 724 P.2d 333, 356 (N.M. Ct. App. 1986), and Baker v. Commercial Body Builders, Inc., 507 P.2d 387 (Or. 1973)).

d. Post-Davis cases

Despite these questionable foundations, cases post-dating *Davis* continue to rely directly or indirectly on the post-*Patton* receivership statute, *Davis*, and out-of-state law in recognizing a minority shareholder claim for "oppression."[161] In particular, courts have repeatedly cited *Davis* for its definition of oppression, since no other definition can be found in Texas jurisprudence.

Until the Texas Supreme Court provides guidance in *Rupe*, Texas courts will likely continue to entertain shareholder oppression as a cause of action, despite the vagueness of the term "oppression."[162] Thus, the following section examines standards or requirements necessary to show "oppression" in Texas.

2. Shareholder Oppression Standards in Texas

The Texas lower courts that have recognized a claim for shareholder oppression have defined it as follows:

> 1. majority shareholders' conduct that substantially defeats the minority's expectations that, objectively viewed, were both reasonable under the circumstances and central to the minority shareholder's decision to join the venture ("Reasonable Expectations"); or
>
> 2. burdensome, harsh, or wrongful conduct; a lack of probity and fair dealing in the company's affairs to the prejudice of some members; or a visible departure from the standards of fair dealing and a violation of fair play on which each shareholder is entitled to rely ("Fair Dealing").[163]

The second definition is particularly subject to criticism,[164] because it is extremely vague and appears grounded in a majority shareholder fiduciary duty or duty of good faith and fair

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[161] *See, e.g.*, Redmon v. Griffith, 202 S.W.3d 225 (Tex. App.—Tyler 2006, pet. denied) (citing *Davis* in reversing summary judgment on shareholder oppression claim); Cotten v. Weatherford Bancshares, Inc., 187 S.W.3d 687 (Tex. App.—Fort Worth 2006, pet. denied) (citing Pinnacle Data Servs., Inc. v. Gillen, 104 S.W.3d 188 (Tex. App.—Texarkana 2003, no pet.), which cites *Davis*, in holding that preferred stockholder may have "oppression" claim against directors); Hoggett v. Brown, 971 S.W.2d 472 (Tex. App.—Houston [14th Dist.] 1997, pet. denied) (citing *Davis* in discussing "fiduciary duty" owed amongst shareholders).

[162] *See, e.g.*, Brief of Appellants, DeNucci v. Matthews, No. 04-11-00680-CV, 2011 Tex. App. Ct. Briefs 680 (Tex. App.—Austin [3rd Dist.] 2012) (appealing trial court's summary judgment denying plaintiffs' claims of minority shareholder oppression).

[163] *See, e.g.*, Willis v. Bydalek, 997 S.W.2d 798, 801 (Tex. App.—Houston [1st Dist.] 1999, pet. denied) (citing *Davis*, 754 S.W.2d at 381–82); Ritchie v. Rupe, 339 S.W.3d 275, 290 (Tex. App.—Dallas 2011, pet. filed); Guerra v. Guerra, No. 04-10-00271-CV, at *11 (Tex. App.—San Antonio Aug. 24, 2011).

[164] *But see* Amicus Curiae letter, submitted on behalf of Respondent, dated Jan. 15, 2013 (stating, "Therefore, the [*Ritchie*] court was on sound footing in adopting its definition of shareholder oppression. Its definition should be endorsed by the Supreme Court of Texas.").

dealing, neither of which is recognized in Texas.[165]

Cases discussing shareholder oppression also inevitably focus on the defendant's malice. For example, in *Gibney v. Culver*,[166] the court evaluated whether there was sufficient evidence that the defendant *maliciously* allowed excessive salaries, *maliciously* withheld dividends, or *maliciously* refused access to books and records to uphold the trial court's finding of shareholder oppression. To the extent that *Patton* is relied on to support a claim for shareholder oppression, it also indicates that malice is a necessary element of the claim.[167] Although Texas courts have never specifically identified malice as an element of shareholder oppression, for practical purposes, a plaintiff must likely prove malice to prevail on this claim.

3. Recent Minority Shareholder Oppression Cases

Shareholder oppression claims are on the rise in Texas. Below are some of the recent key cases decided by Texas courts of appeals.

a. Ritchie v. Rupe: 2011 Dallas Court of Appeals Opinion; Pending Texas Supreme Court Opinion

In accordance with *Davis*, the Dallas Court of Appeals recently recognized a cause of action for minority shareholder oppression. In *Richie v. Rupe*, the plaintiff, a minority shareholder in Rupe Investment Corporation ("RIC") brought claims of shareholder oppression against the other shareholders and directors of RIC.[168] In an effort to sell her stock, the plaintiff first approached RIC to purchase the stock.[169] When the plaintiff and RIC were unable to settle on a price satisfactory to both parties, the plaintiff proceeded to market the stock to third parties.[170] The plaintiff encountered difficulty in obtaining the interest of investors because most investors wanted to meet with RIC's board before making a decision to invest in the close corporation, and RIC's board refused to meet with any prospective purchasers.[171] The trial court found that the plaintiff was the victim of shareholder oppression and ordered the corporation to buyout the plaintiff's stock.[172] The defendants argued that: (1) Court-mandated

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[165] *See* City of Midland v. O'Bryant, 18 S.W.3d 209, 215–16 (Tex. 2000) (no good faith duty in employment context); Formosa Plastics Corp. v. Presidio Engineers and Contractors, Inc., 960 S.W.2d 41, 52 (Tex. 1998) (no good faith duty in "ordinary, arms-length commercial transactions"); Crim Truck and Tractor, Co. v. Navistar Int'l Trans. Corp., 823 S.W.2d 591 (Tex. 1992) (no general duty of good faith and fair dealing in all contracts); FDIC v. Coleman, 795 S.W.2d 706, 708–09 (Tex. 1990) (no good faith duty in lender/borrower relationship); English v. Fischer, 660 S.W.2d 521, 522 (Tex. 1983) (unwilling to let each fact finder decide what is "fair and in good faith").

[166] Gibney v. Culver, No. 13-06-112-CV, 2008 Tex. App. LEXIS 2954, at *56–64 (Tex. App.—Corpus Christi April 24, 2008, pet. denied) (mem. op., not designated for publication).

[167] *See* Patton v. Nicholas, 279 S.W.2d 848, 853 (Tex. 1955) (noting the jury's finding of malice and explaining that "the evidence as to the wrongful state of mind of the petitioner seems quite adequate, and while proof of connection between this state of mind and actual conduct is both small in volume and inferential in character (as it would almost necessarily be) we think it is enough").

[168] *Rupe*, 339 S.W.3d 275, 282 (Tex. App.—Dallas 2011, orig. proceeding [mand. pending]).

[169] *Id.*

[170] *Id.*

[171] *Id.*

[172] *Id.*

buyback of the stock is not an available remedy for shareholder oppression in Texas; (2) As a matter of law, their actions did not constitute shareholder oppression; and (3) The buyout remedy is unduly harsh and inappropriate under the circumstances.[173]

Citing *Davis*, on the first question of whether a buyout is available under Texas law, the court determined that a buyout can be an appropriate remedy "'where less harsh remedies are inadequate to protect the rights of the parties.'"[174] On the second question—the heart of the case—the court looked at whether the actions of the defendants constituted oppression. Applying the two definitions of oppression discussed above, i.e., "Reasonable Expectations" or "Fair Dealing," the court concluded that the defendants acted oppressively toward the plaintiff under both definitions.[175] While the rights of the shareholder and obligations of those in control of the corporation are not boundless, the court determined that the board's actions in refusing to meet with investors substantially defeated the plaintiff's right to sell her stock to a third party.[176] Finally, on the third question of whether ordering a buyout was an unduly harsh remedy, the court concluded that the trial court's ordered buyout was not so harsh as to constitute an abuse of discretion.[177]

i. Petition to the Texas Supreme Court Granted

The Texas Supreme Court granted the defendants' Petition for Review. In presenting the importance of the court's review of this case, the petitioners highlighted the rise of shareholder oppression claims, and the lower courts' need for guidance on evaluating these claims. The petitioners further argued that the court of appeals erred by: (1) holding that the petitioners oppressed the minority shareholder by refusing to meet with prospective purchasers; (2) awarding a remedy beyond those provided in the statute; (3) awarding a remedy that is more burdensome than necessary; and (4) applying the reasonable expectations test.

Thus, the principal issues facing the court include: (1) whether the controlling shareholders and principals of a closely held corporation oppressed a minority shareholder by refusing to meet with potential buyers of her stock; (2) whether shareholder oppression should be proved by a "reasonable expectations" standard or by one showing "burdensome, harsh or wrongful conduct"; (3) whether the Texas receivership statute authorizes a court to order other shareholders to buy the oppressed minority shareholder's stock; and, if so, (4) whether such a stock-buyout remedy was appropriate in this case.

ii. Oral Argument to the Texas Supreme Court

Oral argument was heard by the court on February 26, 2013. The Texas State Bar displayed the following statement of facts and issues during oral argument to the Texas Supreme Court:

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[173] *Id.* at 285.

[174] *Id.* at 286 (quoting Davis v. Sheerin, 754 S.W.2d 375, 380, (Tex. App.—Houston [1st Dist.] 1988, writ denied)).

[175] *Id.* at 293–97.

[176] *Id.* at 297.

[177] *Id.* at 299.

> The principal issues are (1) whether shareholders and principals controlling a closely held corporation oppressed a minority shareholder by refusing to meet with potential buyers of stock she controlled; (2) whether shareholder oppression should be proved by a "reasonable expectations" standard or by one showing "burdensome, harsh or wrongful conduct"; (3) whether the Texas statute addressing oppression authorizes a court to order other shareholders to buy the minority shareholder's stock; and, if so, (4) whether such a stock-buyout remedy was appropriate in this case. This dispute involves stock in a family company, Rupe Investment Corp. of Dallas. All stock in Rupe Investment is held by descendants of Dallas businessmen Dallas Gordon Rupe Jr. ("Pops") and Robert Ritchie or by trusts for their descendants. Ann Rupe, in charge of a trust her late husband established to hold his shares ("Buddy's Trust"), sued Ritchie and other Rupe Investment directors because they refused to meet with potential buyers of the stock she controlled. The other directors cited liability problems they might face by meeting with would-be buyers. Rupe hired a broker to sell the stock after she refused the directors' offers to buy her stock for as much as $1.7 million. The broker priced it as high as $3.4 million, but testified no purchaser would buy it without meeting with the directors. Finding oppression, the trial court ordered Rupe Investment to buy the stock for $7.3 million after a jury determined that to be its fair market value. The court of appeals affirmed the trial court's oppression finding, but reversed to revalue the stock. The appeals court held that jurors should have been instructed to account for Ann Rupe's minority-shareholder status and the lack of a ready market for the stock.

The court questioned counsel on the standards on which the court should evaluate the allegedly oppressive conduct, the scope of the cause of action, appropriate remedies, and what conduct can constitute oppression. Petitioner's counsel argued for a limited cause of action with a "burdensome and harsh" standard (rather than the "reasonable expectation" standard) that encompasses only narrow statutory remedies, i.e., a rehabilitative receivership. Respondent's counsel urged oppressive acts separate from the board's failure to meet and argued that the court should consider the totality of the circumstances when making the oppression determination. Respondent's counsel also argued that a confidentiality agreement and release drafted by the company and signed by the prospective purchasers relieved the company from any risk for misrepresentation or securities fraud, and so any reliance on a business judgment justification was not warranted.

In closing, the court asked Petitioner's counsel for guidance on the contours of the term "oppression" in the statute. He advised the court to exercise "judicial restraint," and confine itself only to the language currently present in the statute, which, by his submission, provides only for the sole remedy of a rehabilitative receivership. Providing a buyout remedy, in his view, merely incentivizes more shareholder oppression cases (counsel cited an increase in oppression litigation at the same point that a buyout remedy was recognized by judicial opinions and statutes).

How the court will rule on this case is anyone's guess. Hopefully its ruling provides appropriate guidance to assist Texas courts of appeals in handling future oppression claims

equitably and uniformly.

b. Cardiac Perfusion Servs., Inc. v. Hughes, No. 05-10-00286-CV (Tex. App.—Dallas 2012, pet. filed).

In another recent shareholder oppression case, the court ignored otherwise binding terms of a shareholder buy-sell agreement, and instead ordered an "equitable" buyout remedy on completely different terms.[178] In *Cardiac Perfusion*, Joubran (plaintiff) and Hughes (defendant) worked as cardiac perfusionists (i.e., they operated heart-lung machines during open-heart surgery).[179] Plaintiff founded Cardiac Perfusion Services ("CPS") and hired defendant as his employee.[180] Defendant accepted an opportunity to purchase stock in CPS, and the parties entered into a Buy-Sell Agreement.[181] The Agreement provided that, if a shareholder is terminated, the other shareholders of CPS must buy his stock based on book value of the shares the previous year.[182] A dispute arose between the parties years later, and defendant was terminated.[183]

Plaintiffs sued defendant for breach of fiduciary duty and tortious interference with a contract, and defendant counterclaimed for shareholder oppression.[184] The jury found in favor of defendant on all claims.[185] With respect to defendant's counterclaim, the jury found that Joubran: (1) withheld payment or profit distribution to defendant; (2) paid himself excessive compensation; (3) improperly used funds to pay personal expenses and pay family members; (4) lowered the value of defendant's stock; and (5) concealed books and records from defendant.[186]

Despite an enforceable Buy-Sell Agreement,[187] the trial court ordered the redemption of the minority shareholder's shares at fair value.[188] While noting that "Texas courts have held that a party to a contract cannot recover equitable relief inconsistent with that contract," the appellate court considered the minority shareholder's claim that the book value of his shares was reduced by the oppressive conduct, and because the shareholder "sued for shareholder oppression, not breach of contract," the court exercised its "equitable power to order a buy-out at fair value."[189]

At first glance, the appellate court's decisions in *Rupe* and *Cardiac Perfusion* suggest that

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178 *Cardiac Perfusion Servs., Inc. v. Hughes*, No. 05-10-00286-CV (Tex. App.—Dallas 2012, pet. filed).

179 *Id.* at *1.

180 *Id.*

181 *Id.*

182 *Id.*

183 *See id.*

184 *Id.*

185 *Id.* at *2.

186 *Id.*

187 The Buy-Sell Agreement stated that the purchase price was "calculated using the book value of the shares as of the fiscal year preceding the termination." *Id.* at *1.

188 *Id.* at *2–3.

189 *Id.* at *4–5.

the threshold for identifying acts as "oppressive" is relatively low. The majority shareholders in *Rupe* did not *thwart* the minority shareholders right to sell her stock, but merely—on the advice of counsel—refused to meet with prospective buyers, yet the court determined that the majority shareholder's actions constituted oppression. That threshold seems to be a moving target, however, as other Texas courts have set the threshold much higher.[190] The Texas Supreme Court will finally weigh in when it decides *Rupe* later this year.

c. Guerra v. Guerra, No. 04-10-00271-CV, 2011 WL 3715051 (Tex. App.—San Antonio Aug. 24, 2011).

Yet another Texas appellate court—though ultimately holding against the minority shareholder—recently entertained a claim for shareholder oppression. In *Guerra*, a sister brought suit against her brother following their father's death for numerous claims, including breach of fiduciary duty and minority shareholder oppression.[191] The trial court granted the brother's motion for summary judgment, and the sister appealed.[192] The brother was appointed independent executor of their father's estate, and had acted as president of Laredo Hardware, the family-owned company (started by their father), for the five years prior to their father's death.[193] The father owned thirty-eight percent of the shares of Laredo Hardware, and the sister and brother, along with four other family members owned the remainder.[194] Laredo Hardware elected not to purchase the father's shares, and offered the sister the opportunity to purchase them.[195] She declined, and instead offered to sell her shares to her brother.[196] When her brother rejected her offer, she filed suit.[197]

The sister claims that her brother breached his fiduciary duty as an officer and director of Laredo Hardware, and—by refusing to liquidate Laredo Hardware following their father's death—engaged in minority shareholder oppression.[198] She requested that the court require her brother and Laredo Hardware to buyout her shares.[199] Specifically, the sister claimed that her brother breached his fiduciary duties by, among other things: (1) "usurping a corporate opportunity when he purchased the land on which Laredo Hardware is located; and (2) failing to liquidate Laredo Hardware."[200] The brother defended against these claims by arguing (among other things) that he owed his sister no fiduciary duties as an officer and director or as a majority shareholder, her claims are barred by the business judgment rule, and the board of

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[190] *See, e.g.*, Allen v. Devon Energy Holdings, LLC, 367 S.W.3d 355, 398–99 (Tex. App.—Hous. [1st Dist.] 2012, no pet.); ARGO Data Resource Corp. v. Balkrishna Shagrithaya, 380 S.W.3d 249 (Tex. App.—Dallas 2012, pet. filed).

[191] Guerra v. Guerra, No. 04-10-00271-CV, at *1 2011 WL 3715051 (Tex. App.—San Antonio Aug. 24, 2011).

[192] *Id.* at *1–2.

[193] *Id.* at *2.

[194] *Id.*

[195] *Id.*

[196] *Id.*

[197] *Id.*

[198] *Id.* at *3.

[199] *Id.*

[200] *Id.*

directors rejected the opportunity to purchase the land and approved the lease.[201]

The court held that the brother did not have authority to liquidate Laredo Hardware, and that he "did not have a duty to persuade shareholders in a corporation to liquidate the company."[202] In response to the sister's claim for breach of fiduciary in his capacity as director and officer, the court—citing *Redmon*—concluded that the brother owed no fiduciary duty to his sister in his capacity as director and officer because "a corporate shareholder has no individual cause of action for personal damages caused by a wrong done solely to the corporation."[203]

Finally, and most crucial to this discussion, the court separately addressed the sister's claim for shareholder oppression.[204] She made this claim based on allegations that her brother used Laredo Hardware for his personal gain.[205] The court applied the definition/standard of "oppressive conduct" as outlined below, finding no evidence of shareholder oppression under the first prong (a shareholder's expectations when investing in the corporation) because the sister received her shares as a bequest from her father.[206] The court further found no evidence of oppression under the second prong (the majority shareholders' conduct) because the evidence showed that the brother did not usurp a corporate opportunity.[207] The brother presented the opportunity to purchase the land to the board, and the offer was declined.[208] Furthermore, the board minutes also show that after the brother purchased the land, he presented the lease agreement to the board for its approval, and the board agreed.[209] The court held that the brother's acts were not oppressive and affirmed that aspect of the trial court's judgment.[210]

d. ARGO Data Resource Corp. v. Shagrithaya, 380 S.W.3d 249 (Tex. App.—Dallas 2012, pet. filed).

ARGO involved a claim of minority shareholder oppression brought by the plaintiff Shagrithaya (the sole minority shareholder of ARGO) against both ARGO and Max Martin ("Martin") (the sole majority shareholder). Following a jury trial, the trial court signed a judgment in favor of Shagrithaya ordering Martin to cause ARGO to issue a one-time $85 million dividend as equitable relief for Martin's alleged oppressive conduct. The judgment further awarded Shagrithaya damages for breach of contract and attorneys' fees. Finally, the judgment awarded ARGO damages and equitable relief based on acts found by the jury to constitute a breach of fiduciary duty by Martin.[211]

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201 *Id.* at *4–5.

202 *Id.* at *7.

203 *Id.* at *9 (citing Redmon v. Griffith, 202 S.W.3d 225, 236 (Tex. App.—Tyler 2006, pet. denied)).

204 *See id.* at *10.

205 *Id.*

206 *Id.* at *11.

207 *Id.* at *11–12.

208 *Id.* at *12.

209 *Id.* at *13.

210 *Id.*

211 ARGO Data Resource Corp. v. Shagrithaya, 380 S.W.3d 249, 257 (Tex. App.—Dallas 2012, pet. filed).

At trial, the jury found eleven acts that plaintiff claimed supported a judicial finding of shareholder oppression. The appellate court reversed the trial court's judgment and rendered a take-nothing judgment in favor of the defendants, finding that none of Martin's alleged wrongful acts constituted oppression of the minority shareholder Shagrithaya.[212]

The appellate court first clarified the jury's role with regard to shareholder oppression claims, noting that "[i]t is within the province of the jury as fact finders to determine whether certain acts occurred."[213] However, "the determination of whether such acts constitute shareholder oppression is a question of law for the court."[214]

The court began its review by stating "Courts must exercise caution in determining what actions constitute oppressive conduct[,]" and reiterated that "[a] corporation's officers and directors are afforded broad latitude in conducting corporate affairs and the minority shareholder's expectations must be balanced against the corporation's need to exercise its business judgment and run its business efficiently."[215]

The appellate court then parsed through Martin's alleged eleven wrongful acts to determine whether (1) legally and factually sufficient evidence existed to support the jury's findings; and (2) whether the jury's factual determinations supported a legal finding of oppression.[216] In concluding that "Shagrithaya failed to show his entitlement to relief on any of his individual or derivative claims," the appellate court made a number of findings relating to the specific factual and legal allegations before the court.[217] For instance, the court found that "[t]o the extent Shagrithaya expected . . . to maintain a level of compensation [in the form of salary] equal to Martin's indefinitely regardless of circumstances or his position in the company, we conclude that, without an agreement pertaining to compensation, such an expectation was not reasonable."[218] The court said, "Texas law does not recognize a minority shareholder's right to continued employment without an employment contract."[219]

The court then addressed the plaintiff's claims related to resolutions passed by the Board over his vote, stating "the inability to control board decisions is inherent in the position of a minority shareholder," and did not form a basis for an oppression claim.[220] The court rejected the jury finding that Martin's action in directing ARGO to retain earnings, rather than issue dividends "resulted in lowering the value of Shagrithaya's stock."[221] Instead, the court found "[t]he evidence shows that the value of the company and Shagrithaya's shares continued to grow throughout the time period that Shagrithaya claims Martin was suppressing dividends. Shagrithaya directs us to no evidence that the value of his shares was affected by Martin's

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212 *Id.*

213 *Id.* at 264.

214 *Id.*

215 *Id.* at 265.

216 *See id.* at 264, 270–72.

217 *Id.* at 257.

218 *Id.* at 266.

219 *Id.*

220 *Id.* at 266–67.

221 *Id.* at 269.

actions [in having ARGO retain more earnings]."[222] The court found "[t]o the extent . . . that the jury's findings could be read as finding that Shagrithaya was individually targeted for the purpose of preventing him from sharing in the profits of the company or that the value of his shares was depreciated by Martin's actions, we conclude the evidence is legally insufficient to support such findings."[223] Moreover, the court noted that "Texas law does not require a corporation to issue dividends," and that "[i]t is within the discretion of the board of directors whether a dividend will issue."[224] Therefore, "although Shagrithaya may disagree with the reasons behind Martin's decision to have ARGO retain its earnings, he could have had no general reasonable expectation as a shareholder of receiving dividends."[225]

The court next found that the fair market value offer Martin made to buy out Shagrithaya's shares (which included a minority discount) did not constitute oppression, as "the mere offer to purchase the shares for fair market value cannot amount to oppression. Although Shagrithaya argues that he would be forced to accept the discounted offer because of the lack of dividends . . . he was under no financial pressure to accept the offer and, in fact, he did not accept it."[226]

The court concluded that "the evidence does not support a finding of fraud or shareholder oppression, including malicious suppression of dividends," and determined the "trial court erred in ordering the equitable remedy of an $85 million dividend," as well as the trial court's remaining judgment against the defendants.[227]

In a pending Petition for Review to the Texas Supreme Court, the petitioner (Shagrithaya) claims that the court in *Rupe* found oppression for "far less egregious conduct" than was present in *ARGO*.[228] The petitioner claims that "[t]he abuse of the minority ownership in this case is more extensive and of longer duration than any ever addressed in a reported Texas opinion."[229] The Petition for Review is currently pending in the Texas Supreme Court.

e. Allen v. Devon Energy Holdings, LLC, 367 S.W.3d 355 (Tex. App.—Hous. [1st Dist.] 2012).

Another appellate court denied a claim for shareholder oppression amidst allegations of material misrepresentations and a failure to disclose material facts in connection with the redemption of the minority shareholder's interest.[230] In *Allen*, the plaintiff ("Allen") and defendant ("Rees-Jones") were partners at a law firm until Rees-Jones left the firm to work in

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222 *Id.*

223 *Id.* at 269–70.

224 *Id.* at 270.

225 *Id.*

226 *Id*. at 272.

227 *Id*. at 274.

228 Pet. for Review at 3, Shagrithaya v. Argo Data Resource Corp., No. 05-10-00690-CV (Tex. Dec. 14, 2012).

229 *Id.* at 12.

230 Allen v. Devon Energy Holdings, LLC, 367 S.W.3d 355, 398–99 (Tex. App.—Houston [1st Dist.] 2012, pet. granted, judgm't vacated w.r.m.).

the oil and gas industry.[231] Years later, Rees-Jones approached Allen about investing in an oil and gas company ("Chief").[232] Allen became a minority shareholder, and Chief experienced significant success.[233] In November 2003, Rees-Jones sent Chief's members a letter of intent to make redemption offers, and Allen accepted and redeemed his minority interest.[234] The closing, however, was delayed until June 2004.[235]

Two years after Allen redeemed his interest, Chief sold for nearly twenty times the value used to calculate Allen's redemption price.[236] Allen alleged that Rees-Jones induced him to sell his interest by making material misrepresentations and failing to disclose material information crucial to the deal.[237] Allen brought suit against Rees-Jones and Chief for, among other things, minority shareholder oppression.[238] Both the trial court and the appellate court denied Allen's claim for shareholder oppression.[239]

In evaluating Allen's claim for shareholder oppression, the court applied the two definitions of shareholder oppression commonly applied by Texas courts.[240] The court also discussed the need to balance the minority shareholder's reasonable expectations with the corporation's need to exercise its business judgment.[241] Ultimately the court concluded that the alleged wrongful conduct was not the typical wrongdoing in shareholder oppression cases, e.g., termination of employment, denial of access to books and records, improperly withholding dividends, wasting corporate assets, payment of excessive compensation, or refusing access to corporate offices.[242] The court further explained that shareholder oppression claims are unnecessary when the shareholder has non-disclosure and breach of fiduciary duty claims.[243] Because Allen provided no authority for allowing fraudulent conduct or breaches of fiduciary duty to form the basis of a shareholder oppression claim, the court upheld the trial court's denial of this claim.[244]

The trial court granted Rees-Jones's motion for summary judgment on Allen's breach of fiduciary duty claim.[245] Allen argued that summary judgment was improper, and that both formal and informal fiduciary duties existed.[246] The appellate court held that Rees-Jones failed to conclusively establish that he did not owe Allen a formal fiduciary duty in connection with

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231 *Id.* at 366.
232 *Id.*
233 *Id.* at 366.
234 *Id.* at 367.
235 *Id.*
236 *Id.*
237 *Id*.
238 *Id.* at 398–99.
239 *Id.* at 399.
240 *Id.* at 398–99.
241 *Id.* at 399 (citing Richie v. Rupe, 339 S.W.3d 275, 289 (Tex. App.—Dallas 2011, pet. filed)).
242 *Id*.
243 *Id*.
244 *Id*.
245 *Id*. at 388.
246 *Id.*

the redemption, and thus, did not reach the issue of whether an informal fiduciary relationship existed.[247] The Texas Supreme Court will not weigh on this case, as the parties settled their claims while on appeal.[248]

4. Equitable Remedies for Oppression in Texas

The Texas Supreme Court has held that courts of equity should impose the least restrictive equitable remedy possible.[249] When imposing the least restrictive remedy, the court must balance two principles: (1) the relief must provide full relief to the injured shareholder; and (2) the full relief should impose the smallest possible burden on the corporation.[250] One remedy for oppressive conduct by majority shareholders is a buyout of the minority shareholder's shares.[251] Other remedies include reinstating the position and benefits to a shareholder who was previously removed; requiring a forced declaration of mandatory dividends; full disclosure to the oppressed shareholder of meetings and documents; and finally, as the most extreme remedy, the court can order dissolution of the company.

5. Avoiding or Limiting Liability for Shareholder Oppression

Until the Texas Supreme Court clarifies the law on shareholder oppression, practitioners must rely on indications from other cases for strategies to defend against and limit liability for such claims. The following sections discuss methods of defending against shareholder oppression claims in Texas.

a. The Business Judgment Rule

A trial court cannot substitute its judgment for that of a proper corporate business strategy. Courts must allow proper deference to corporate decision making.[252] Notably, in the shareholder oppression context, the business judgment rule does not provide a complete defense, but instead requires a balancing of competing interests. To that end, courts in Texas "must exercise caution, balancing the minority shareholder's reasonable expectations against the corporation's need to exercise its business judgment and run its business efficiently."[253]

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[247] *Id.*

[248] Allen v. Devon Energy Holdings, LLC, No. 01-09-00643-CV, 2013 Tex. App. LEXIS 656, at *1–2 (Tex. App.—Houston [1st Dist.] Jan. 24, 2013).

[249] *See* Patton v. Nicholas, 279 S.W.2d 848, 857 (Tex. 1955).

[250] *In re* White, 429 B.R. 201, 215–16 (Bankr. S.D. Tex 2010).

[251] Douglas K. Moll, *Shareholder Oppression in Texas Close Corporations: Majority Rule (Still) Isn't What it Used to Be*, 9 HOUS. BUS. & TAX L.J. 33, 56–57 (2008).

[252] *See, e.g.*, Gibney v. Culver, No. 13-06-112-CV, 2008 Tex. App. LEXIS 2954, at *58–59 (Tex. App.—Corpus Christi Apr. 24, 2008, pet. denied) (mem. op.) (recognizing that business judgment is given broad latitude to be balanced against claims of shareholder oppression); Willis v. Bydalek, 997 S.W.2d 798, 801 (Tex. App.—Houston [1st Dist.] 1999, pet. denied) ("Courts must exercise caution in determining what shows oppressive conduct. The minority shareholder's reasonable expectations must be balanced against the corporation's need to exercise its business judgment and run its business efficiently.") (citing McCauley v. Tom McCauley & Son, Inc., 724 P.2d 232, 237 (1986); Landstrom v. Shaver, 561 N.W.2d 1, 8 (S.D. 1997)).

[253] *See* ARGO Data Resource Corp. v. Shagrithaya, 380 S.W.3d 249, 265 (Tex. App.—Dallas 2012, pet. filed); *see also* Richie v. Rupe, 339 S.W.3d 275, 295–96 (Tex. App.—Dallas 2011, pet. filed) (but stating that the "business

b. The Limits Found in the Texas Receivership Statute Apply to All Shareholder Oppression Claims

Because most cases that recognize a claim for shareholder oppression base the claim, at least in part, on the receivership statute, the requirements of that statute arguably should apply to all shareholder oppression claims. The statute provides relief against conduct: (1) by the *board*; (2) that affects the well-being of the *corporate* entity *and* damages an interested party; (3) for which there continues to be a need for the relief; and (4) for which there is *no other adequate remedy of law* or equity.[254]

Assuming these requirements apply to all shareholder oppression claims, the board may also be able to avoid liability by remedying past oppressive conduct. In doing so, the minority shareholder might encounter difficulty showing that the need for relief continues to exist.

c. Conduct That Does Not Rise to the Level of Oppression

When Texas courts have granted equitable relief in favor of a minority shareholder, the alleged oppression has involved malicious conduct to exclude or severely reduce the minority shareholder's expected financial or participatory role in the corporation. For example, courts have granted equitable relief for the following oppressive conduct:

- Deprivation or *denial* of the minority shareholder's stock ownership;[255]
- Business practices that decrease cash or profits for the purpose of avoiding payment of dividends;[256]
- *De facto* dividends to the majority shareholder that result in disproportionate financial participation that prejudices the minority shareholder's financial interests or rights;[257] and

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judgment rule has no application in this case" because "this is not a derivative suit for breach of the duty of care owed by the corporation.").

[254] *See* TEX. BUS. ORGS. CODE ANN. § 11.404 (West 2012) (emphasis added).

[255] *See* Davis v. Sheerin, 754 S.W.2d 375, 377 (Tex. App.—Houston [1st Dist.] 1988, writ denied) (majority shareholder denied minority shareholder "any interest or voice" by refusing to allow inspection of books unless he surrendered his stock certificate that he claimed had been gifted to him, despite corporate records to the contrary).

[256] *See* Patton v. Nicholas, 279 S.W.2d 848, 853–54 (Tex. 1955) (inferring that majority shareholder "pile[d] up profits in the form of property other than cash . . . to excuse withholding dividends . . . "); *Davis*, 754 S.W.2d at 382 (evidence that majority shareholders desired to *disburse surplus funds to officers* as bonuses rather than disburse dividends in which minority shareholder would participate) (emphasis added).

[257] *See Patton*, 279 S.W.2d at 851–52 (after firing and removing the minority shareholders as directors within months of incorporation, the majority shareholder tripled his salary but declared he "would see to it that no dividends would be paid so long as the respondents were stockholders" and "he would not buy the stock of respondents for even a small fraction of its value or sell his own at any price"); *Davis*, 754 S.W.2d at 382 (majority shareholders "received informal dividends by making profit sharing contributions for their benefit and to the exclusion of [the minority shareholder]").

- Complete expulsion of the minority shareholder from corporate governance or from actively participating in the business in contradiction of and substantially defeating his reasonable expectations in deciding to "join" the business.[258]

In contrast, the following situations do not support a claim for shareholder oppression:

- Frustration with corporate management;[259]
- Voluntary departure from a director, officer or employee position;[260]
- Temporarily withholding dividends from all shareholders alike;[261]
- Failure to pay annual employment compensation equal to other board members when there was no agreement to do so.[262] Without an agreement, an expectation to maintain an equal salary to other board members indefinitely is not reasonable;[263]
- Retaining company's earnings to buy out minority's interest;[264] and
- Misrepresentations and failure to disclose information that induces a minority shareholder to redeem his stock.[265]

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[258] *See Patton*, 279 S.W.2d at 854 (firing and removing minority shareholders as directors with "intent to eliminate the respondents from every connection with the business"); *Davis*, 754 S.W.2d at 382 (special board meeting minutes reflecting that minority shareholders' "opinions [or actions] would have no effect on the Board's deliberations" after the filing of the lawsuit).

[259] *See* Texarkana College Bowl, Inc. v. Phillips, 408 S.W.2d 537, 539 (Tex. App.—Texarkana 1966, no writ) (statute not satisfied by allegations of "dissatisfaction with corporation management").

[260] *See* Allchin v. Chemic, Inc., No. 14-01-00433-CV, 2002 Tex. App. LEXIS 5125, at *9 (Tex. App.—Houston [14th Dist.] July 18, 2002, no pet.) (not designated for publication) ("An employee who voluntarily leaves the employment of a corporation presents a less persuasive case for concluding the majority shareholders oppressed him.").

[261] *See* Gibney v. Culver, No. 13-06-112-CV, 2008 Tex. App. LEXIS 2954, at *60–61 (Tex. App.—Corpus Christi April 24, 2008, pet. denied) (mem. op.) (two year withholding of dividends did not establish shareholder oppression when *no shareholders* received dividends during this time and minority shareholder received compensation from corporation in another form) (emphasis added); *see also* ARGO Data Resource Corp. v. Shagrithaya, 380 S.W.3d 249, 269–70 (Tex. App.—Dallas 2012, pet. filed).

[262] *See ARGO Data Resource Corp.*, 380 S.W.3d at 266 ("An expectation of annual employment compensation cannot be said to be a general expectation held by all shareholders of a company.").

[263] *Id.*

[264] *See id.* at 270 ("Buying out a minority shareholder's interest is not an improper purpose for retaining a company's earnings[,]" and is only improper if it negatively impacts the minority shareholder's rights, i.e., prevents him from sharing in the profits of the company or the value of his shares in the marketplace is depreciated).

[265] Allen v. Devon Energy Holdings, LLC, 367 S.W.3d 355, 399 (Tex. App.—Houston [1st Dist.] 2012, pet. granted, judgm't vacated w.r.m.) (stating that no case has extended shareholder oppression to include causes of action for fraud by misrepresentation and breach of fiduciary duty).

To the extent the conduct complained of does not rise to the level of conduct described in the former set of cases and instead more closely resembles the latter set of cases, a court will be unlikely to find shareholder oppression.

d. The Alleged Wrongful Conduct Must Relate to Shareholder Rights and Injuries

Breach of an obligation to the corporation cannot form the predicate for an individual "shareholder oppression" claim.[266] Likewise, injury to the corporation by itself is insufficient to establish shareholder oppression.[267] Put another way, the wrongful conduct must bear a nexus to shareholder rights.[268]

e. The Relief Must be Tailored to the Wrong

The equitable relief granted for shareholder oppression must be tailored to fit the wrongful conduct.[269] When redressing the injury caused to the shareholder, the court must impose the least burdensome remedy possible on the corporation.[270]

The United States Bankruptcy Court for the Southern District of Texas hammered home this concept in its analysis in a 2010 case, *In re White*. There, the court concluded that the corporation intended to deprive and did deprive a shareholder of its reasonable expectations to share in the corporation's profits, and such actions constituted oppression.[271] In determining the appropriate remedy, the court acknowledged its responsibility to provide full relief to the aggrieved shareholder, but that in doing so, it must impose the least burdensome alternative on the corporation.[272] The court decided two options that would remedy the corporation's oppressive conduct, but could not determine which alternative would be the least onerous on the corporation.[273] Ultimately, the court presented two possible remedies to the corporation:

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[266] *See* Wingate v. Hajdik, 795 S.W.2d 717, 719 (Tex. 1990) (a stockholder may recover for damages caused to him by breach of an obligation "'ow[ed] directly by [a wrongdoer] to the stockholder.'") (citing Massachusetts v. Davis, 168 S.W.2d 216, 222 (Tex. 1942), *cert. denied*, 320 U.S. 210 (1943)).

[267] *See* TEX. BUS. ORGS. CODE ANN. § 11.404 (West 2012) (requiring harm to the well-being of the corporate entity and damage to an interested party); *Wingate*, 795 S.W.2d at 719 ("[T]he individual stockholders have no separate and independent right of action for injuries suffered by the corporation which merely result in the depreciation of the value of their stock.") (citation omitted); *see also ARGO Data Resource Corp.*, 380 S.W.3d at 272 (holding that shareholders "have no independent cause of action and cannot recover personally for misappropriation of corporate assets").

[268] *See, e.g.*, Patton v. Nicholas, 279 S.W.2d 848, 854 (Tex. 1955) (detailing "wrongful conduct of the petitioner" that blocked all minority shareholders from all financial participation in corporation); Davis v. Sheerin, 754 S.W.2d 375, 383 (Tex. App.—Houston [1st Dist.] 1988, writ denied) (finding shareholder oppression based on a conspiracy to "deprive [the shareholder] of his interest in the corporation . . . and the undisputed evidence indicating that [the shareholder] would be denied any future voice in the corporation . . . ").

[269] *See Patton*, 279 S.W.2d at 857 ("Wisdom would seem to counsel tailoring the remedy to fit the particular case."); *Davis*, 754 S.W.2d at 380 (recognizing remedy must be tailored to fit the case).

[270] *In re* White, 429 B.R. 201, 215 (Bankr. S.D. Tex. 2010).

[271] *Id*. at 214.

[272] *Id.* at 215–16.

[273] *Id.* at 216.

(1) a buyout of the minority shareholder's interest in the corporation; or (2) a permanent injunction to protect the minority shareholder's future expectations, and allowed the corporation to elect the remedy it preferred.[274]

f. Actual Damages are Sufficient to Compensate the Aggrieved Shareholder

When actual damages are sufficient to compensate the minority shareholder and no equitable relief is needed to protect his interests, the minority shareholder's remedies should be limited to actual damages.[275]

g. Minority Shareholder's "Reasonable Expectations" Measured at Time Shareholder Joins the Enterprise

Even the court of appeals' opinions adopting the cause of action require that the majority shareholder's actions must substantially defeat the reasonable financial or participatory expectations that were central to the minority shareholder's decision to become a minority shareholder *at the time of his or her investment*.[276] The minority shareholder's requested relief at trial is sometimes directly contrary to the shareholder's expectations at the time of the initial investment in the corporation. The *Rupe* case held that some expectations "may develop over time among the shareholders," seeming to indicate that an expectation that differs from the minority shareholder's decision to join the venture may be considered only if it is one shared "among the shareholders" as a whole.[277]

C. Shareholder Oppression Law in Delaware

Although Delaware does not have a statute directly addressing shareholder oppression, it does have developed standards to evaluate a claim of breach of fiduciary duty brought by a minority shareholder for alleged oppressive conduct by the controlling shareholder or director. These standards protect not only the minority shareholders from potential oppression, but also the directors or controlling shareholders in knowing how courts will evaluate their actions. Thus, unlike Texas' amorphous and uncertain shareholder oppression cases to date, Delaware's standards provide protection and advantageous predictability.

1. Standards to Determine Director/Controlling Shareholder Liability

This section illustrates the general rules that have developed in Delaware regarding

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[274] *Id.* at 216–19.

[275] *See* Davis v. Sheerin, 754 S.W.2d 375, 383 (Tex. App.—Houston [1st Dist.] 1988, writ denied) (evaluating whether remedy was adequate to "protect appellee's interest and [] rights in the corporation").

[276] *See* Gibney v. Culver, No. 13-06-112-CV, 2008 Tex. App. LEXIS 2954, at *58 (Tex. App.—Corpus Christi Apr. 24, 2008, pet. denied) (mem. op.) (" . . . substantially defeats the minority shareholder's expectations that, objectively viewed, were both reasonable under the circumstances and central to the minority shareholder's decision to join the venture"); Redmon v. Griffith, 202 S.W.3d 225, 234 (Tex. App.—Tyler 2006, pet. denied); Allchin v. Chemic, Inc., No. 14-01-00433-CV, 2002 Tex. App. LEXIS 5125, at *20 (Tex. App.—Houston [14th Dist.] July 18, 2002, no pet.); Willis v. Bydalek, 997 S.W.2d 798, 801 (Tex. App.—Houston [1st Dist.] 1999, pet. denied); *Davis*, 754 S.W.2d at 381.

[277] *See* Richie v. Rupe, 339 S.W.3d 275, 291 (Tex. App.—Dallas 2011, pet. filed).

majority and minority shareholder rights, detailing the three standards of review applied by Delaware courts to evaluate director decision making. The business judgment standard remains Delaware's default standard and the standard most lenient to directors and controlling shareholders. The business judgment standard *presumes* that the directors made an educated decision in good faith and in the best interests of the company.[278]

The enhanced scrutiny standard is an intermediate standard of review and applies in cases where "the realities of the decision[]making context can subtly undermine the decisions of even independent and disinterested directors."[279] If this standard applies, the fiduciaries bear the burden of persuasion to show that the motives behind their actions were proper.[280]

The final and most onerous standard is the entire fairness standard. Once the plaintiff has rebutted the applicability of the business judgment standard, which favors upholding decisions of the board, he then enjoys the more plaintiff-friendly standard of entire fairness. Notably, the Delaware Supreme Court has stated, "[i]t is often of critical importance whether a particular decision is one to which the business judgment rule applies or the entire fairness rule applies. It is sometimes thought that the decision whether to apply the business judgment rule or the entire fairness test can be outcome-determinative."[281] Each of these standards and cases applying each standard are described in more detail below.

a. The Business Judgment Standard: Delaware's Default and Most Lenient Standard

Delaware courts approached the first claims alleging oppressive conduct by directors and controlling shareholders against minority shareholders with caution. Some of the earliest cases denied claims brought by minority shareholders, giving great deference to the director's discretion in business decisions.[282]

The business judgment rule is a "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[283] A hallmark of the business judgment rule is that a court will not substitute its judgment for that of the board if the latter's decision "can be attributed to any rational business purpose."[284] Some Delaware courts treat the business judgment rule as an explicit standard of review while others reject its

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278 *See* Reis v. Hazelett Strip-Casting Corp., 28 A.3d 442, 457 (Del. Ch. 2011).

279 *Id.*

280 *Id.*

281 Nixon v. Blackwell, 626 A.2d 1366, 1376 (Del. 1993).

282 *See, e.g.*, Davis v. Louisville Gas & Elec. Co., 142 A. 654, 659 (Del. Ch. 1928) ("The judgment of the directors of corporations enjoys the benefit of a presumption that it was formed in good faith and was designed to promote the best interests of the corporation they serve."); *see also* Mercantile Trading Co. v. Rosenbaum Grain Corp., 154 A. 457, 461 (Del. Ch. 1931) ("[G]enerally . . . courts will not upset the decisions of either directors or stockholders as to questions of policy and business management . . . [f]raud, actual or presumed, or illegal or *ultra vires* misconduct must be shown to justify an interference by the courts with such decisions.").

283 Gantler v. Stephens, 965 A.2d 695, 705–06 (Del. 2009) (citations omitted).

284 Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971).

characterization as a standard of review and instead view it as an abstention policy to avoid the court's involvement altogether. In all practicality, its application as a standard resembles an abstention policy, thus its function is essentially the same. The most recent Delaware Chancery Court's opinion explicitly describes the business judgment rule as a standard by which to evaluate directors and controlling shareholders' decisions.[285]

iii. *Davis v. Louisville Gas & Elec. Co.*, 142 A. 654 (Del. Ch. 1928).

In an early case, *Davis v. Louisville Gas & Electric Co.*, the defendant corporation, Louisville Gas and Electric Co., owned the great majority of the Class B stock, which carried the sole voting rights.[286] The board of directors proposed an amendment to the certificate of incorporation, with the effect that whenever Class A and Class B stocks had each received dividends of $1.50 per share, all dividends should be declared share and share alike between the two Classes; and likewise the permission to redeem Class A stock at $32.50 per share was eliminated.[287] Dissenting stockholders of Class B filed a bill against the corporation to restrain the passing of the amendment, arguing that the proposed changes were unfair and illegal, as it would take away their material and fundamental contract rights.[288]

The Court of Chancery denied plaintiffs' request for a restraining order.[289] It held that the proposed amendments to the certificate of incorporation were permitted by statute, and that the directors were *presumed* to be acting in the best interests of the corporation by proposing the changes.[290] The court first pointed out that the Delaware Corporation Law permitted corporations to adopt amendments of the kind proposed; and second, that the terms were not unfair and inequitable because management insisted it was for the best interests of the corporation, permitting additional capital to be obtained by sale of its Class A stock.[291]

Moreover, there was no evidence of fraud, since most of the directors held the Class B stock that allegedly would have been negatively affected by the changes.[292] The court accordingly held that *unless* it could be shown that the directors were not "acting in good faith," the amendment should be sustained.[293]

iv. *Revlon, Inc. v. Macandrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

Revlon marked the Delaware courts' modern trend in recognizing and protecting the rights

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[285] *See* Reis v. Hazelett Strip-Casting Corp., C.A. No. 3552-VCL, 2011 Del. Ch. LEXIS 11, at *23 (Del. Ch. Jan. 21, 2011).

[286] Davis v. Louisville Gas & Elec. Co., 142 A. 654, 654 (Del. Ch. 1928).

[287] *Id.* at 659.

[288] *Id.*

[289] *Id.* at 660.

[290] *Id.* at 659.

[291] *Id.*

[292] *Id.* at 660.

[293] *Id.*

of minority shareholders, and a decline in the once heavily relied on business judgment rule.[294] In that case, the Delaware Supreme Court affirmed the Chancery Court's decision to grant a preliminary injunction precluding Revlon, Inc. from consummating a proposed transaction that effectively ended an active and ongoing auction to acquire the company.[295] The court held that Revlon's directors did not act in the shareholders' best interest in ending the corporate auction and allowed considerations other than maximizing shareholder profit to affect their judgment.[296] The court concluded that the directors' actions were not entitled to the protection of the business judgment rule.[297]

The trial court enjoined the transactions on the grounds that defendants had breached their duty of care by entering into such dealings, thus ending an active auction for the company.[298] Essentially, the breach occurred because defendants made concessions to Forstmann, rather than maximizing the sale price of the company for the shareholders' benefit.[299] On appeal, defendants claimed that they did not breach the business judgment rule.

The Delaware Supreme Court affirmed. The court held that: (1) lockups and related agreements are permitted under Delaware law where their adoption is untainted by director interest or other breaches of fiduciary duties; (2) actions taken by directors in the instant case did not meet that standard; (3) concern for various corporate constituencies is proper when addressing a takeover threat; (4) that principle is limited by the requirement that there be some rationally related benefit accruing to the stockholders; and (5) there were no such benefits in the instant case.[300]

The court declared that, in certain limited circumstances indicating that the sale or break-up of the company is inevitable, the fiduciary obligation of the directors of a target corporation are narrowed significantly; the singular responsibility of the board is to maximize the company's value by securing the highest price available for shareholders.[301] In such a context, that conduct is not to be judicially reviewed pursuant to the traditional business judgment rule, but instead will endure enhanced scrutiny for reasonableness in relation to this discrete obligation.[302] A board that takes action to favor one bidder over another in such a way as to halt an active bidding contest has not acted reasonably and has breached its duty to maximize immediate shareholder value.[303]

v. *Benihana of Tokyo, Inc. v. Benihana, Inc.*, 906 A.2d 114 (Del. 2006).

Although *Revlon* slowed the trend of routine reliance on the business judgment rule, it still

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294 Revlon, Inc. v. Macandrews & Forbes Holdings, Inc.,506 A.2d 173 (Del. 1986).
295 *Id.* at 175.
296 *Id.* at 185.
297 *Id.*
298 *Id.* at 175–76.
299 *Id.* at 179.
300 *Id.* at 176.
301 *Id.* at 182.
302 *Id.*
303 *Id.* at 185.

has a presence in modern cases.[304] In that case, defendant restaurant operator, Benihana, Inc. ("Benihana") was a subsidiary of plaintiff holding corporation, Benihana of Tokyo, Inc. ("BOT").[305] Due to financial problems and a change of corporate control, three of the members of the subsidiary's board of directors considered the issuance of convertible stock and its sale to a potential buyer.[306] Ultimately, the entire board approved resolutions ratifying the execution of a stock purchase agreement with the buyer and authorizing the issuance of preferred stock with preemptive rights.[307] Thereafter, the plaintiff filed an action against all but one of the subsidiary's directors, alleging breaches of fiduciary duties.[308] The Court of Chancery entered judgment in the defendant's favor, holding that the board's approval was a valid exercise of the business judgment rule, and the plaintiff appealed.[309]

The Delaware Supreme Court held that the subsidiary's certificate of incorporation did not prohibit the issuance of preferred stock with preemptive rights.[310] In reaching its opinion, the court analyzed and interpreted the corporate charter and Delaware law (DGCL Section 144) involving safe harbors for interested transactions.[311] Section 144 provides that when a transaction is known to the board of directors and they, in good faith, authorize the transaction by affirmative votes of a majority of disinterested directors, the transaction will be reviewed under the business judgment rule.[312]

The court noted that the transaction was approved by a majority of informed, disinterested and independent directors, and that the directors did not have an improper purpose of entrenchment.[313] The directors otherwise acted in conformity with their fiduciary duties in the belief that the preferred equity financing represented the best means to finance the subsidiary's operation.[314] Consequently, the board's approval of the transaction was a legitimate exercise of its business judgment, for a proper corporate purpose, under Delaware Code sections 144(a)(1) and 102(b)(3).[315]

b. Enhanced Scrutiny: Delaware's Intermediate Standard of Review

As stated above, the enhanced scrutiny standard provides an intermediate standard of review to evaluate a director's decision making. It falls squarely between the leniency of the business judgment standard, and the stringent entire fairness standard. This standard is used "when the realities of the decision[]making context can subtly undermine the decisions of even

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304 *See, e.g.*, Benihana of Tokyo, Inc. v. Benihana, Inc., 906 A.2d 114 (Del. 2006).
305 *Id.* at 116.
306 *Id.* at 116–18.
307 *Id.* at 118.
308 *Id.* at 119.
309 *Id.*
310 *Id.* at 120.
311 *Id.* at 120–21.
312 *Id.* at 120.
313 *Id.* at 121–22.
314 *Id.*
315 *Id.* at 120–22.

independent and disinterested directors."[316] It essentially requires that "the defendant fiduciaries 'bear the burden of persuasion to show that their motivations were proper and not selfish' and that 'their actions were reasonable in relation to their legitimate objective.'"[317]

The enhanced scrutiny standard has been employed in certain specific situations, such as (1) defensive action by a director against a hostile takeover; (2) directors facing a proxy contest; (3) directors intruding on stockholders' right to vote; and (4) final stage transactions.[318]

i. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

This case involved the directors' actions with regard to a takeover bid.[319] Mesa Petroleum ("Mesa") made an unsolicited attempt to acquire a majority control of Unocal through a two-tiered, front-loaded offer for Unocal's outstanding shares.[320] Mesa's bid was structured as follows: first, there would be a cash tender offer for 37% of Unocal's outstanding shares at $54 each; and second, the shareholders that failed to tender in the first round would be forced to exchange their Unocal shares in the second round for highly subordinated securities that Unocal labeled as "junk bonds."[321] In response, Unocal's boards of directors proposed to have Unocal repurchase its own shares at $72 each but excluded Mesa from the self-tender offer.[322] The Court of Chancery entered a preliminary injunction requested by Mesa, and the directors appealed.[323]

In addressing the applicable standard of review in the context of an unsolicited takeover bid and change in control, the court explained that the board faces a potential conflict between protecting its own interests versus those of the corporation and the shareholders.[324] As such, the directors' actions should be subject to an enhanced level of scrutiny as a threshold test before being afforded the protections of the business judgment rule.[325]

The court then articulated the contours of the enhanced scrutiny review.[326] Enhanced scrutiny would require the board to meet its own initial two-part burden.[327] First, the board must show that it had reasonable grounds for its belief that a threat existed to corporate control

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316 Reis v. Hazelett Strip-Casting Corp., C.A. No. 3552-VCL, 2011 Del. Ch. LEXIS 11, at *20 (Del. Ch. Jan. 21, 2011).

317 *Id.* (quoting Mercier v. Inter-Tel Inc., 929 A.2d 786, 810 (Del. Ch. 2007)).

318 *See, e.g.*, Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985); Aprahamian v. HBO & Co., 531 A.2d 1204, 1206 (Del. Ch. 1987); *Mercier,* 929 A.2d at 809–10; Lonergan v. EPE Holdings, LLC, 5 A.3d 1008, 1019 (Del. Ch. 2010).

319 *Unocal Corp.*, 493 A.2d 946.

320 *Id.* at 949.

321 *Id.* at 949–50.

322 *Id.* at 951.

323 *Id.* at 951–52.

324 *Id.* at 955.

325 *Id.* at 954.

326 *Id.* at 955.

327 *Id.*

or policy.[328] This determination would be made based on the board's showing of good faith and having conducted a reasonable investigation.[329] Second, the board must show that the defensive measures selected by the board were reasonable and proportionate in relation to the threat posed.[330]

The board presented evidence to persuade the court that the actions it took were reasonably related to the threat posed.[331] Specifically, the court stated that:

> [T]he board's decision to offer what it determined to be the fair value of the corporation to the 49% of its shareholders, who would otherwise be forced to accept highly subordinated "junk bonds," is reasonable and consistent with the directors' duty to ensure that the minority stockholders receive equal value for their shares.[332]

Once the board met this burden, its action was entitled to be measured by the standards of the business judgment rule.[333] The Delaware Supreme Court ultimately held that the directors had the power and duty to oppose a takeover threat they reasonably perceived as being harmful to the corporation, and that the action taken was entitled to protection under the business judgment rule.[334]

ii. *Mercier v. Inter-tel (Del.) Inc.*, 929 A.2d 786 (Del. Ch. 2007).

Mercier involved a merger and acquisition. In that case, Inter-Tel (Delaware), Incorporated ("Inter-Tel") announced that it had reached an agreement with Mitel Networks Corporation ("Mitel"), pursuant to which Mitel would acquire Inter-Tel. On May 29, 2007, Inter-Tel gave notice that a special meeting to consider the Mitel merger would be held a month from that date, with a record date of May 25th.[335] The majority shareholder responded by sending a letter to Inter-Tel's stockholders expressing his opposition to the merger.[336] On June 19th, Institutional Shareholder Services ("ISS") recommended that stockholders vote "no" with respect to the Mitel merger and expressed its dissatisfaction with the purported failure of the Inter-Tel board to run a full-fledged auction prior to striking a deal with Mitel.[337] As the June 29th meeting date approached, a Special Committee of Inter-Tel's board of directors considered a number of factors that potentially supported rescheduling of the meeting.[338] Additionally, several stockholders had indicated a preference for the postponement, and ISS had indicated that its recommendation could change if the vote was

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328 *Id.*
329 *Id.*
330 *Id.*
331 *Id.* at 956–57.
332 *Id.* at 957.
333 *Id.* at 958.
334 *Id.* at 954.
335 *See* Mercier v. Inter-tel (Del.) Inc., 929 A.2d 786 (Del. Ch. 2007).
336 *Id.*
337 *Id.* at 793.
338 *Id.* at 795.

postponed and Inter-Tel disclosed additional financial information.[339] On the morning of the June 29th meeting date, Inter-Tel's directors knew that the merger would fail to achieve approval if the meeting went forward, and "believed the stockholders were about to make a huge mistake" in voting down the transaction. The Special Committee therefore announced that the meeting would be rescheduled, and offered a new meeting date.[340] Significantly, after the meeting was rescheduled and additional information was disclosed, ISS changed its recommendation from "no" to "yes" on the proposed merger agreement.[341] The Mitel merger was approved by an overwhelming majority of Inter-Tel's stockholders at the rescheduled special meeting.[342]

The court stated that the appropriate standard of review should be "a reasonableness standard consistent with the *Unocal* standard," i.e., the enhanced scrutiny standard, which is typically invoked in the context of board defensive action.[343] Applying a modified *Unocal* standard to the facts of *Inter-Tel*, the court stated that the Special Committee retained the burden of first identifying a "legitimate corporate objective" served by its decision to reschedule the special meeting, thus requiring that the directors demonstrate that "their motives were proper and not selfish."[344] Inter-Tel's directors, who would be replaced if the Mitel merger were consummated, satisfied this first requirement because they believed that the Mitel merger was in the best interests of stockholders, and that stockholders would benefit from additional information and time to consider the transaction.[345]

Having shown that the meeting postponement met a legitimate corporate objective, the Inter-Tel Special Committee was then required to demonstrate that its objective in rescheduling the meeting was reasonable, and that the postponement would neither preclude stockholders from exercising their voting rights, nor coerce stockholders into voting for or against the proposed merger.[346] The court concluded that the Special Committee had acted reasonably in delaying the vote for a short period of time in order to provide additional information to stockholders prior to the merger vote.[347] The court also determined "summarily" that the postponement was neither preclusive nor coercive to stockholder voting rights, since stockholders of record remained free to vote either for or against the merger at Inter-Tel's rescheduled meeting.[348] The decision of the Inter-Tel Special Committee to postpone an imminent stockholder vote therefore met intermediate scrutiny under the court's reformulated *Unocal* test.[349]

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339 *Id.*
340 *Id.* at 798.
341 *Id.* at 801.
342 *Id.* at 803.
343 *Id.* at 810.
344 *Id.*
345 *Id.* at 813.
346 *Id.* at 810.
347 *Id.* at 814–19.
348 *Id.* at 817.
349 *Id.* at 821.

iii. *In re Del Monte Foods Co. Shareholders Litigation,* 25 A.3d 813 (Del. Ch. 2011).

This case involves unscrupulous behavior by Del Monte Foods Company's ("Del Monte") financial advisor, Barclays Capital ("Barclays"). Del Monte entered into a merger agreement with Blue Acquisition Group (owned by Kohlberg, Kravis, Roberts & Co. ("KKR"), Centerview Partners ("Centerview"), and Vestar Capital Partners ("Vestar")).[350] The plaintiffs sought to postpone the vote on the merger, asserting claims for breach of fiduciary duty against the Del Monte board for "failing to act reasonably to pursue the best transaction reasonably available."[351]

A review of the evidence showed that Barclays deceitfully manipulated the sale process and devised a highly self-serving transaction that allowed Barclays to obtain buy-side financing fees.[352] At the outset, Barclays was heavily involved in discussing an acquisition of Del Monte with potential acquirers.[353] After Del Monte shut down the sale of the company, Barclays continued to meet with several bidders (unbeknownst to Del Monte), eventually generating a bid late in 2010 from KKR of $17.50 per share.[354] Barclays and the bidders actively concealed from Del Monte the fact that Vestar was also heavily involved in the bid by KKR.[355]

After some negotiations but before the parties had settled on a price, Barclays finally requested what it had secretly desired all along: to provide buy-side financing to KKR.[356] Del Monte agreed, thus allowing Barclays to provide financing for the deal while negotiating with KKR on price.[357] In November 2010, KKR made its final offer of $19 per share.[358] The board approved the merger agreement.[359]

The terms of the merger agreement provided a 45-day post signing go-shop period and deal protection devices such as matching rights and a termination fee of $60 million.[360] During this 45-day period, Barclays contacted 53 parties, and none expressed interest in purchasing Del Monte.[361]

The court applied the enhanced scrutiny standard of review and determined that the directors satisfied the objective prong by successfully demonstrating that they sought to

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350 *In re* Del Monte Foods Co. S'holders Litig., 25 A.3d 813, 817 (Del. Ch. 2011).

351 *Id.*

352 *Id*.

353 *Id.* at 820.

354 *Id.* at 823.

355 *Id.*

356 *Id.* at 825–26.

357 *Id.* at 826.

358 *Id.*

359 *Id.* at 827.

360 *Id.* at 827–28.

361 *Id.* at 828.

achieve the best transaction possible for the shareholders.[362] The court then turned to the subjective prong: the directors must show that "their actions were reasonable in relation to their legitimate objective."[363]

Even applying the enhanced scrutiny, the court showed an inclination towards the business judgment rule, stating, "Enhanced scrutiny 'is not a license for law-trained courts to second-guess reasonable, but debatable tactical choices that directors have made in good faith.'"[364] The court noted that unreasonableness can generally be found by acts that jeopardize the integrity of the process, such as self-interest, undue favoritism, or disdain towards a particular bidder.[365]

The court examined the directors' reliance on expert advisors and the behavior of those advisors.[366] The court found the acts by Barclays, particularly the active concealment of information from the board, to be egregious.[367] In addition to these improper acts by Barclays, the court found that two of the board's acts were unreasonable: (1) failing to meaningfully consider Vestar's proposed participation; and (2) allowing Barclay to act as one of KKR's lead banks while still negotiating price.[368]

After thoroughly discussing the egregious acts of Barclays and though seemingly empathizing with the board earlier in its opinion, the court then states, "Although the blame for what took place appears at this preliminary stage to lie with Barclays, the buck stops with the Board."[369] When a board relies on the advice of advisors, normally its decisions, when made with the proper exercise of business judgment, will not be disrupted.[370] However, if the board is misled by conflicted advisors, "the protections girding the decision itself vanish."[371] In this case, the court concluded that the board was deceived by Barclays and that the plaintiffs showed that the board failed to act reasonably.[372] The court enjoined the board from conducting the shareholder vote for twenty days.[373]

iv. *In re Openlane, Inc. Shareholders Litigation*, Const. C.A. No. 6849-VCN, 2011 Del. Ch. LEXIS 156 (Del. Ch. Sept. 30, 2011).

This suit stems from a proposed merger of Openlane with a wholly-owned subsidiary wherein the purchasing entities proposed paying $210 million (approximately $8.30 per share)

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362 *Id.* at 830.

363 *Id.* (citing Mercier v. Inter-tel (Del.) Inc., 929 A.2d 786, 810 (Del. Ch. 2007).

364 *Id.* at 831 (citing *In re* Toys "R" Us, Inc. S'holder Litig., 877 A.2d 975, 1000 (Del. Ch. 2005)).

365 *Id.* at 831.

366 *Id.* at 833.

367 *Id.* at 834.

368 *Id.* at 835.

369 *Id*.

370 *Id.* at 836. (citing Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1283–84 (Del. 1989)).

371 *Id.*

372 *Id.*

373 *Id.* at 844.

to purchase Openlane in an all-cash transaction.[374] Plaintiff brought suit against defendants for breach of their fiduciary duties in failing to take an adequate process to sell Openlane and failing to disclose material information.[375] Plaintiff also filed a motion for a preliminary injunction to enjoin the merger.[376] The court, applying the enhanced scrutiny standard, held in favor of the defendants and denied the injunction.[377]

Openlane's primary business involved selling leased vehicles turned in by lessees.[378] In April 2010, the board predicted a decline in the number of vehicles coming off lease in the near future, and worked with a third company to locate strategic acquirers.[379] After negotiations with several potential purchasers, the board unanimously approved the merger with KAR.[380] It proceeded to receive consents from a majority of Openlane's preferred and common stockholders, as required by Delaware law.[381]

The plaintiff filed suit, claiming that the process used by the board was flawed, and in violation of *Revlon*.[382] Plaintiff criticized the defendants for contacting only three potential buyers, failing to perform an adequate market check, failing to receive a fairness opinion, and relying on inadequate financial information, which resulted in a transaction that failed to maximize shareholder value.[383] The plaintiff further contended that the defendants "breached their fiduciary duties by agreeing to improper deal protection devices," e.g., the no-solicitation clause and lockup of the shareholder vote.[384] Plaintiff questioned the board's motives for approving the merger.[385]

Because it was a change in control transaction, the court applied the enhanced scrutiny standard, recognizing that the board had "the burden of proving that they were adequately informed and acted reasonably."[386] In the context of a preliminary injunction, however, the defendant "must establish a reasonable likelihood that at trial the [board] would not be able to show that [it] had satisfied [its] fiduciary duties."[387] Examining the facts, the court determined that the board here represented one of the rare boards that "possess an impeccable knowledge of the company's business," and that the board made reasonable efforts to maximize shareholder value.[388] The court determined that the plaintiff failed to present a compelling

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[374] In re Openlane, Inc. S'holders Litig., Const. C.A. No. 6849-VCN, 2011 Del. Ch. LEXIS 156, at *1 (Del. Ch. Sept. 30, 2011).

[375] *Id.* at *8.

[376] *Id.*

[377] *Id.* at *46.

[378] *Id.* at *1–2.

[379] *Id.* at *3.

[380] *Id.* at *4–6.

[381] *Id.* at *6.

[382] *Id.* at *10.

[383] *Id.*

[384] *Id.*

[385] *Id.* at *11.

[386] *Id.* at *15.

[387] *Id.*

[388] *Id.* at *17–20.

argument to support its request for injunctive relief.[389]

The court then applied the standard outlined in *Unocal* to examine the plaintiff's claim for breach of fiduciary duty based on the board's use of defensive devices that resulted in a lock up of the merger.[390] Under the first prong, the board must show that it had reasonable grounds for believing a danger to corporate policy existed.[391] This prong can be satisfied by "demonstrating good faith and reasonable investigation," which must lead to the finding of a threat.[392] The second prong required the board to show that its response was "reasonable in relation to the threat posed."[393] The anticipated decline in Openlane's business provided the danger and threat required under the first prong.[394] The court rejected the impermissible lock up claim on the grounds that the votes were not "locked up" according to a voting agreement, but instead, after the board approved the merger agreement, a majority of the holders "quickly provided consents."[395] As such, the court concluded that the merger agreement "neither forced a transaction on the shareholders, nor deprived them of the right to receive alternative offers."[396]

In balancing the equities, the court expressed concern in maximizing shareholder value when the sale lacks "an auction, a fairness opinion, a fiduciary out, or any post-agreement market check."[397] However, the court noted that here, no other offers came forward, and the board members were competent and had the same incentive to maximize value as all minority shareholders.[398] This decision suggests that Delaware courts will respect and uphold the reasonable decisions of an knowledgeable board, even if they deviate from customary practice.

c. The Entire Fairness Standard: Delaware's Most Onerous Standard

To avoid application of the business judgment standard, the plaintiff must produce evidence that refutes the business judgment presumption.[399] There are a number of ways the plaintiff can rebut the business judgment presumption, including by showing that the majority of directors who approved the action (1) had a personal interest in the subject matter of the action; (2) were not fully informed in approving the action; or (3) did not act in good faith in approving the action.[400] If the plaintiff rebuts the business judgment presumption, the court applies the entire fairness standard of review to the challenged action and places the burden on the directors to prove that the action was entirely fair.[401]

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389 *Id.* at 20.

390 *Id.* at *21–22.

391 *Id.* at *22.

392 *Id.* (citing Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140, 1152 (Del. 1989)).

393 *Id.* (citing Unocal Corp v. Mesa Petroleum, 493 A.2d 946, 955 (Del. 1985)).

394 *Id.* at *23–24.

395 *Id.* at *25.

396 *Id.* at *26.

397 *Id.* at *45.

398 *Id.* at *45–46.

399 Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1162 (Del. 1995).

400 Ebay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 36 (Del Ch. 2010).

401 *Id.*

The concept of fairness has two basic elements: fair dealing and fair price.[402] Fair dealing examines issues such as: "when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained."[403] The element of fair price examines the economic and financial considerations of the transaction, including relevant factors such as: "assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock."[404] All aspects of the two elements must be considered as a whole to determine entire fairness.[405]

Notably, if the director or controlling stockholder implements two protective components, then the transaction can evade the entire fairness review.[406] The two components are: (1) the controlling shareholder must permit "the board to form a duly empowered and properly functioning special committee"; and (2) the transaction must be conditioned on approval by a "majority-of-the-minority vote."[407] If the controlling shareholder employs both of these components to protect the minority shareholder, "then the burden could shift to the plaintiff to prove that the transaction was unfair," essentially avoiding the entire fairness review and invoking the business judgment rule.[408]

v. *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).

In *Weinberger v. UOP, Inc.*, the Delaware Supreme Court applied the standard of entire fairness in the context of a freeze-out merger.[409] There, the Signal Companies ("Signal") owned 50.5% of subsidiary UOP and sought to acquire the remaining shares in a cash-out merger.[410] Signal's initial offer of $20 a share was raised to $21 after UOP formed an independent committee to negotiate.[411] Signal also provided a fairness opinion from an investment bank claiming that $21 was a fair price.[412] The merger, which required the votes of a majority of UOP's minority shareholders, was eventually approved.[413] However, the shareholders were not told of a feasibility study written by two UOP executives and given directly to Signal that said that a fair price would be $21-$24 a share.[414]

Plaintiff minority shareholders filed suit alleging that the cash-out merger was illegal in that: (1) its sole purpose was to eliminate the minority shareholders; and (2) the price per share

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402 Weinberger v. Uop, 457 A.2d 701, 711 (Del. 1983).

403 *Id.*

404 *Id.*

405 *Id.*

406 Reis v. Hazelett Strip-Casting Corp., 28 A.3d 442, 460 (Del. Ch. 2011).

407 *Id.* (citing *In re* Cox Commc'ns, Inc. S'holders Litig., 879 A.2d 604, 644 (Del. Ch. 2005)).

408 *Id.*

409 *See* Weinberger v. UOP Inc., 457 A.2d 701 (Del. 1983).

410 *Id.* at 704–05.

411 *Id.* at 705–06.

412 *Id.* at 706–07.

413 *Id.* at 708.

414 *Id.* at 708–09.

to be paid by minority shareholders was grossly inadequate.[415] Weinberger sought to set merger aside or, in the alternative, an award of monetary damages against the subsidiary, the majority shareholder of corporation, and the investment-banking firm that provided the fairness opinion prior to merger.[416] The Court of Chancery entered judgment for defendants, and plaintiffs appealed.[417]

The Delaware Supreme Court abandoned the business purpose test as a requirement for mergers and returned to the appraisal procedure as the primary remedy for shareholders who can prove a violation of fairness.[418] The court held that the present transaction did not satisfy any reasonable concept of fairness.[419] In so ruling, the court stated that the test of entire fairness has two aspects: *fair dealing* and *fair price*.[420] The fair dealing element focuses upon the conduct of the corporate fiduciaries in effecting a freeze-out merger.[421] The fair price element relates to the economic and financial considerations relied upon when valuing the proposed purchase including assets, including assets, market values, cash flow, and earnings.[422]

The court found that there was not fair dealing because the disclosure to the defendant's directors was wholly flawed by conflicts of interest raised in the feasibility study, and the minority shareholders were denied critical information; therefore, the vote of the minority shareholders was not an informed one.[423] In addition, the price was not fair because the accounting methods that were used to value UOP's stock did not meet section 262(h).[424]

vi. *In re LNR Property Corp. Shareholders Litigation*, 896 A.2d 169 (Del. Ch. 2005).

> [T]he business judgment rule does not protect the board's decision to approve a merger (even where a majority of the directors are independent and disinterested) where a controlling shareholder has a conflicting self-interest. Instead, Delaware law imposes an entire fairness burden when the fiduciary charged with protecting the minority in a sale of the company does not have an undivided interest to extract the highest value for the shareholders.[425]

In that case, former shareholders filed fiduciary class action in connection with a cash-out

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415 *Id.* at 703.
416 *Id.* at 703–04.
417 *Id.* at 703.
418 *Id.* at 715.
419 *Id.* at 712.
420 *Id.* at 711.
421 *Id.* at 711–12.
422 *Id.* at 713–14.
423 *Id.* at 711–12.
424 *Id.* at 713–14.
425 *In re* LNR Prop. Corp. S'holders Litig., 896 A.2d 169, 177 (Del. Ch. 2005) (footnote omitted).

merger, naming LNR Property Corporation and its former directors as defendants.[426] They further alleged that LNR's board of directors breached its fiduciary duties by allowing the controlling stockholder and the chief executive officer ("CEO"), who had "obvious and disabling conflicts of interest, to negotiate the . . . deal."[427] Although the board formed a special independent committee to consider the deal, plaintiffs alleged that the committee was a "sham" because it was "dominated and controlled" by the controlling shareholder and the CEO, and the committee was not permitted to negotiate with the buyer or seek other deals.[428] Additionally, the shareholders claimed that the committee failed to get an independent evaluation of the deal, but relied on a financial advisor who worked with the controlling shareholder and the CEO to negotiate the deal, and stood to gain an $11 million commission when the transaction was completed.[429] Defendants moved to dismiss for failure to state a claim.[430]

The Court of Chancery held that plaintiffs' allegations were sufficient to warrant application of the entire fairness standard of review and wrote: "when a controlling shareholder stands on both sides of a transaction, he or she is required to 'demonstrate [his or her] utmost good faith and most scrupulous inherent fairness of the bargain.'"[431] The court concluded that the complaint could be read to allege that the board improperly allowed the controlling shareholder to control the negations with the acquirer, as well as the outcome of the vote, resulting in an unfair and inadequate price for the stock in the cash-out.[432] The court found that due to the seriousness of the allegations, the business judgment rule would not apply to the transaction.[433] The court also rejected defendants' argument that plaintiffs' claims were barred based on the corporation's exculpatory charter provision because the alleged misconduct implicated defendants' duties of loyalty and good faith.[434]

vii. *Reis v. Hazelett Strip-Casting Corp.*, 28 A.3d 442 (Del. Ch. 2011).

A recent Delaware case, *Reis v. Hazelett Strip-Casting Corp.*, outlined the three standards discussed above, ultimately relying on the entire fairness standard.[435] This case involved a reverse stock split by the corporation that prevented beneficiaries from receiving shares they otherwise would have received.[436] The corporation was a family business, with two brothers as the only stockholders.[437] One brother, Bill held almost seventy percent of the equity in the corporation, while the second brother, Dick, held thirty percent of the equity.[438] Dick, the

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426 *Id.* at 171.

427 *Id.* at 174.

428 *Id.* at 176–77.

429 *Id.* at 174.

430 *In re LNR Prop. Corp.,* 896 A.2d at 174–75.

431 *Id.* at 176 (quoting Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983)).

432 *Id.*

433 *Id.* at 177.

434 *Id.* at 178–79.

435 Reis v. Hazelett Strip-Casting Corp., 28 A.3d 442 (Del. Ch. 2011).

436 *Id.* at 449.

437 *Id.*

438 *Id.* at 450.

minority shareholder, died in 2002, leaving his 350 shares to 169 different individuals.[439] Bill and his son, David, objected to the bequest of Dick's shares to 169 people.[440] Specifically, they worried that such a bequest could jeopardize the business and interfere with the management of the corporation.[441] After an unsuccessful attempt to purchase the estate's shares, the directors approved a reverse stock split and presented the plan at a special meeting of stockholders.[442] The only stockholder present at the meeting to approve the reverse stock split was a limited partnership that was both formed by Bill and held Bill's shares.[443] When the executors refused to accept the payment associated with the reverse split, the corporation and the estate's lawyer asked the probate court to remove the executors, which the court did.[444] One of the recently removed executors continued to oppose the reverse split, bringing suit on behalf of the beneficiaries.[445]

After a brief discussion of the three standards available to the court, it determined that the entire fairness test was the appropriate standard by which to evaluate the reverse split transaction.[446] Applying the two prongs of the entire fairness test (fair dealing and fair price), the court concluded that the reverse split was not entirely fair, and awarded damages.[447]

viii. *In re Southern Peru Copper Corp. Shareholder Derivative Litigation*, 52 A.3d 761 (Del. Ch. 2011).

In a post-trial opinion, Chancellor Strine from the Delaware Court of Chancery—applying the entire fairness standard—concluded that the defendants breached their fiduciary duty of loyalty resulting in a "manifestly unfair transaction."[448] This suit stems from Southern Peru Copper Corporation's ("Southern Peru") acquisition of Minera México ("Minera"), a Mexican mining company, from Groupo México, Southern Peru's controlling shareholder.[449] The court ultimately determined that Southern Peru significantly overpaid to obtain Minera.[450]

Grupo México approached Southern Peru, proposing that Southern Peru acquire Grupo México's interest in Minera.[451] The intended result of the merger would cause Minera to become a wholly-owned subsidiary of Southern Peru.[452] Southern Peru formed a Special Committee and hired Goldman Sachs to evaluate the proposal.[453] However, important to the

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439 *Id.* at 451.
440 *Id.*
441 *Id.*
442 *Id.* at 453.
443 *Id.*
444 *Id.* at 454.
445 *Id.*
446 *Id.* at 461.
447 *Id.* at 479.
448 *In re* S. Peru Copper Corp. S'holder Derivative Litig., 52 A.3d 761, 763, 765 (Del. Ch. 2011).
449 *Id.* at 765–67.
450 *Id.* at 813.
451 *Id.* at 769.
452 *Id.*
453 *Id.* at 769–70.

court's analysis, the Special Committee had no express power to negotiate or explore other strategic alternatives.[454] Goldman Sachs initially determined that the value of what Southern Peru would receive in the transaction was significantly less than the value of stock Groupo México would receive, and made a counterproposal.[455] After some negotiation, a deal was made; however, at that time, the stockholder vote that would be required to approve the merger was still unresolved.[456] Eventually, after accepting a value far below the proposed amount of Southern Peru stock, the Special Committee conceded its majority of the minority provision, and agreed to require only the approval of two-thirds of the outstanding common stock of Southern Peru.[457] Following the transaction, a derivative suit was filed.[458]

Both parties agreed that, because a controlling stockholder stood on both sides of the transaction, the appropriate standard of review was the entire fairness test.[459] Thus, the transaction must meet standards for fair price and fair dealing.[460] The defendants argued that the burden of persuasion shifted to the plaintiff because of their use of an independent Special Committee.[461] The court acknowledged that the burden of persuasion can shift from the defendants if (1) the transaction was approved by an independent board majority; or (2) the transaction was approved by an informed vote of the majority of the minority shareholders.[462] However, the court ultimately determined that the Special Committee did not truly exercise "real bargaining power 'at an arms-length'" and was not "well functioning," and therefore the burden remained with the defendants.[463] The court clarified that factors that trigger the burden shift include the "independence of the committee and the adequacy of its mandates (i.e., was it given blocking and negotiating power)."[464] After an extensive analysis of whether the burden of persuasion should shift to the plaintiff, the court stated:

> As a trial judge, I take very seriously the standard of review as a prism through which to determine a case. When a standard of review does not function as such, it is not clear what utility it has, and it adds costs and complication to the already expensive and difficult process of complex civil litigation. . . . If we take seriously the notion, as I do, that a standard of review is meant to serve as the framework through which the court evaluates the parties' evidence and trial testimony in reaching a decision, and, as important, the framework through which the litigants determine how best to prepare their cases for trial, it is problematic to adopt an analytical approach whereby the burden allocation can only be determined in a post-trial opinion, after all the

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454 *Id.* at 769.
455 *Id.* at 771–75.
456 *Id.* at 777–78.
457 *Id.* at 778.
458 *Id.* at 785.
459 *Id.* at 787.
460 *Id.*
461 *Id.* at 788.
462 *Id.*
463 *Id.* at 789 (quoting Kahn v. Tremont Corp., 694 A.2d 422, 428–29 (Del. 1997)).
464 *Id.* at 791.

evidence and all the arguments have been presented to the court.[465]

Nonetheless, the court noted that it was required to take "a factual look at the actual effectiveness of the special committee before awarding a burden shift."[466] It further stated that "[r]egardless of who bears the burden, I conclude that the Merger was unfair to Southern Peru and its stockholders."[467] The defendants then argued that the burden of persuasion shifted because they "ultimately received super-majority support of the stockholders."[468] The court quickly disregarded this argument, stating that "any burden-shifting should not depend on the after-the-fact vote result but should instead require that the transaction has been conditioned up-front on the approval of a majority of the disinterested stockholders."[469] The court further concluded that the vote was not "fully informed."[470] The court reiterated that "even if the vote shifted the burden of persuasion, it would not change the outcome."[471]

After wading through the burden-shifting analysis, the court finally reviewed the transaction under the entire fairness standard.[472] The court concluded that "from inception, the Special Committee fell victim to a controlled mindset and allowed Grupo México to dictate the terms and structure of the Merger."[473] Such an arrangement "took off the table other options that would have generated a real market check and also deprived the Special Committee of negotiating leverage to extract better terms."[474] This narrowed lens caused the Special Committee to try and make the merger make sense without evaluating whether "the Merger was a good idea in the first place."[475] Finding that "Goldman and the Special Committee went to strenuous lengths to equalize the values of Sothern Peru and Minera,"[476] the court ultimately concluded that the deal was unfair and that the defendants breached their fiduciary duty of loyalty.[477]

2. True Shareholder Oppression Claims: Litle v. Waters, No. 12155, 1992 WL 25758, (Del. Ch. Feb. 11, 1992).

As evidenced by the previous discussion, most cases in Delaware involving oppression suffered by the minority shareholders at the hands of directors and controlling shareholders are presented as claims of breach of fiduciary duty. The Delaware Court of Chancery tackled the issue of oppression head-on in *Litle v. Waters*.[478] While other cases have suggested the

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465 *Id.* at 792–93 (citation omitted).
466 *Id.* at 793.
467 *Id.*
468 *Id.*
469 *Id.*
470 *Id.* at 794.
471 *Id.* at 797.
472 *See id.*
473 *Id.* at 798.
474 *Id.*
475 *Id.* at 801.
476 *Id.*
477 *Id.* at 813.
478 Litle v. Waters, No. 12155, 1992 WL 25758, (Del. Ch. Feb. 11, 1992).

possibility of a minority shareholder claim in Delaware, *Litle* has been cited as the "only Delaware case that has squarely addressed the issue of oppression."[479]

In *Litle*, the plaintiff and the defendant jointly formed two subchapter S corporations.[480] Subsequently, the defendant fired plaintiff and merged the two companies while retaining the subchapter S status.[481] Although the new corporation reported earnings, the board did not declare dividends.[482] Therefore, the plaintiff was forced to pay taxes from personal funds and could not use any cash distributions of the corporation.[483]

The plaintiff filed suit against the defendant alleging that the failure to issue dividends constituted a breach of fiduciary duties and "gross and oppressive abuse of discretion."[484] The defendant argued that "the declaration and payment of a dividend rests in the discretion of the corporation's board of directors in the exercise of its business judgment."[485]

In determining the plaintiff's claim of fiduciary breach, the court held that the entire fairness standard applied because of the defendant's self-interest in the challenged transactions.[486] The court noted that the defendant served his own personal financial interests in making the decision not to declare dividends because he was then able to receive a greater share of cash available for corporate distributions via loan repayments.[487] The defendant was also able to pressure the minority shareholder to sell his shares back to the defendant at a steep discount, since the shares became only a liability to the plaintiff who received no corporate distributions yet owed taxes on the company's income.[488]

Noting that no Delaware case has defined the legal standard for "oppression," the court looked elsewhere for guidance to determine whether the defendant's withholding of dividends was an oppressive abuse of discretion.[489] The court relied in particular on the New York case of *Gimpel v. Bolstein*,[490] which recognized the principal standard for oppression as violation of "reasonable expectations."[491] Applying the reasonable expectation test, the court held that the defendant's scheme represented a "classic squeeze[-]out situation," noting that the failure to

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[479] Orloff v. Shulman, No. 852-N, 2005 Del. Ch. LEXIS 184, at *29 n.52 (Del. Ch. Nov. 23, 2005); *see also* Gagliardi v. Trifoods Int'l, Inc., 683 A.2d 1049, 1051 (Del. Ch. 1996) (stating that the court "need not address the general question whether Delaware fiduciary duty law recognizes a cause of action for oppression of minority shareholders; [and] . . . assum[ing] for purposes of this motion, without deciding, that under some circumstances it may.").

[480] *Litle*, 1992 WL 25758, at *1.

[481] *Id.*

[482] *Id.* at *2.

[483] *Id.*

[484] *Id.* at *6.

[485] *Id.* at *3.

[486] *Id.* at *5.

[487] *Id.* at *4.

[488] *Id.* (Though the minority's shares were never sold).

[489] *Id.* at *7.

[490] Gimpel v. Bolstein, 477 N.Y.S.2d 1014 (N.Y. Sup. Ct. 1984).

[491] *Litle*, 1992 WL 25758, at *7–8.

pay dividends can be especially devastating in a subchapter S corporation.[492] The defendant's refusal to declare dividends when it was in a position to do so "was a visible departure from the standards of fair dealing and fair play."[493] As such, the court determined it could potentially provide relief for the oppression claims, and denied the defendant's motion to dismiss those claims.[494] Despite the fact that the court determined it *could* possibly grant relief under the circumstances, the court also noted "that '[f]ew, if any, cases have involved a set of facts egregious enough to meet [the fraudulent, oppressive or gross abuse of discretion] standard.'"[495] Given that no other Delaware case has "squarely addressed" or recognized a separate claim for shareholder oppression,[496] the *Litle* court's limiting statement that "few, if any, cases" are egregious enough to mount the high burden for such a claim remains true today in Delaware.[497]

3. Benefits of the Developed Standards

The three standards discussed above provide some predictability in how the Delaware courts will handle claims for oppression or breach of fiduciary duty. These standards protect not only the minority from any potential oppression, but also the controlling shareholders or directors in structuring their management in accordance with the standards. A prime example of the protection available to directors and controlling shareholders involves the directors' ability to enjoy review under the business judgment standard and avoid review under the entire fairness standard if the directors implement the two protective elements discussed previously (if done properly).[498] The developed standards of Delaware in this area of law, unlike the amorphous body of law in Texas, provide protection for both minority and controlling shareholders.

However, while the standards provide some guidance, if not applied consistently, such standards are useless. A recent decision from the Delaware Court of Chancery has encountered some criticism after applying the *Revlon* standard of review to analyze a merger involving consideration consisting of approximately 50% cash and 50% stock.[499]

In Re Smurfit-Stone Container Corp. Litigation involved a proposed merger of a publicly held corporation, Smurfit-Stone Container Corp. ("Smurfit"), with a wholly-owned subsidiary of another publicly held corporation, Rock-Tenn Co. ("Rock-Tenn").[500] The proposal provided that the Smurfit shareholders would receive $35 per share, with half of the consideration in

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[492] *Id.* at *8.

[493] *Id.*

[494] *Id.* at *9.

[495] *Id.* (quoting Blackwell v. Nixon, No. 9041, 1991 WL 194725 (Del. Ch. Sept. 26, 1991), *rev'd*, 626 A.2d 1366 (Del. 1993)).

[496] Orloff v. Shulman, No. 852-N, 2005 Del. Ch. LEXIS 184, at *29 n.52 (Del. Ch. Nov. 23, 2005).

[497] *Litle,* 1992 WL 25758, at *9.

[498] *See In re* S. Peru Copper Corp. S'holder Derivative Litig., 52 A.3d 761 (Del. Ch. 2011).

[499] *See In re* Smurfit-Stone Container Corp. S'holder Litig., No. 6164-VCP, 2011 WL 2028076, at *11 (Del. Ch. May 24, 2011) (applying the standard of review established in Revlon, Inc. v. MacAndrews & Forbes Holding, Inc., 506 A.2d 173 (Del. 1986)).

[500] *Id.* at *1.

cash, and the other half in Rock-Tenn's stock.[501] The plaintiffs challenged the merger, claiming that the price per share was unreasonable.[502] The plaintiffs further claimed that the merger warranted heightened scrutiny under the *Revlon* standard because of the resulting "change in control," forcing the court to consider at what point a mixed stock and cash merger constitutes a change of control and requires application of the *Revlon* standard.[503]

Because the merger would liquidate half of each investor's investment—despite the fact that control of Rock-Tenn would remain with unaffiliated stockholders following the merger—the court determined that the facts triggered the *Revlon* standard, but noted that its conclusion was "not free from doubt."[504] Applying the *Revlon* standard, the court concluded that the board of directors satisfied its fiduciary duties and denied injunctive relief.[505]

Critics have attacked the court's application of the *Revlon* standard under these circumstances, contending that there was "no change in control." Both companies were publicly held with no controlling shareholder and would remain the same post-merger; thus, the control essentially remained unchanged.[506] According to this view, because the *Revlon* standard was not triggered, the court should have applied the more lenient business judgment rule. While the application would not have changed the outcome in the current case (i.e., the defendants prevailed even under the more stringent *Revlon* standard),[507] it does have the potential to affect future outcomes.

4. Taking the "Minority" Position: Protecting the Majority in Shareholder Oppression Claims

Delaware courts have demonstrated a historical preference that the parties should be left to the bargain made, whether it be for a majority or minority shareholder position. In accordance with this preference, several Delaware cases go to some lengths to protect the rights of *majority* shareholders against incursion by the board or minority shareholders.

a. Nixon v. Blackwell, 626 A.2d 1366, 1380 (Del. 1993).

Delaware courts have alluded to the minority shareholder's ability to contract for a better position before acquiring an interest in the corporation. In *Nixon*, the Delaware Supreme Court stated:

> The tools of good corporate practice are designed to give a purchasing minority stockholder the opportunity to bargain for protection before parting with consideration. It would do violence to normal corporate practice and our corporation law to fashion an ad hoc ruling which would result in a court-imposed stockholder

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501 *Id.*
502 *Id.*
503 *Id.* at *10.
504 *Id.* at *11.
505 *Id.* at *26.
506 *See id.* at *11.
507 *Id.*

buy-out for which the parties had not contracted.[508]

There, the founder of E.C. Barton & Co., a closely held corporation, created two classes of stock, with voting Class A shares going to either current or past employees of the company, and non-voting Class B shares allocated to family members of the founder.[509] There was no public market for either class of stock.[510] The company retained most of its earnings and paid only modest dividends.[511] Recognizing its shareholders' needs for liquidity, the company offered to purchase the Barton family stock.[512] Several family members sold over the years, although they were not always satisfied with price offered.[513] Employee stockholders were also given the option to sell their shares to the company at various times.[514] Those who acquired their interest in Barton stock through an Employee Stock Ownership Plan ("ESOP") were able to take cash instead of stock at the time of retirement.[515] The family members brought suit against the directors of the company, complaining that defendants had maintained a discriminatory policy that unfairly favored employee shareholders over plaintiffs.[516] Specifically, the defendants are charged with having breached their fiduciary duties by distributing the company's profits through the ESOP rather than dividends, thereby excluding plaintiffs.[517]

The Delaware Supreme Court, applying the entire fairness standard, held that the vice chancellor erred as a matter of law in concluding that substantially equal treatment was required as to plaintiffs, because it was well-established that stockholders need not always be treated equally for all purposes.[518] There was evidence that ESOP was established to benefit the corporation.[519] The court held that the defendants had met their burden of establishing entire fairness of dealings with the plaintiffs, because the record was sufficient to conclude that the plaintiffs' claim that defendant directors had maintained a discriminatory policy of favoring Class A employee stockholders over Class B non-employee stockholders was without merit.[520]

The court held that there should not be any "special, judicially-created rules to 'protect' minority stockholders of closely held Delaware corporations."[521] The court noted that Delaware has passed legislation enabling shareholders in closely held corporations to modify their relationships by contract: "A stockholder who bargains for stock in a closely held

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[508] *Nixon v. Blackwell*, 626 A.2d 1366, 1380 (Del. 1993).
[509] *Id.* at 1370–71.
[510] *Id.* at 1371.
[511] *Id.* at 1373.
[512] *Id.* at 1371.
[513] *Id.*
[514] *Id.*
[515] *Id.*
[516] *Id.* at 1373.
[517] *Id.*
[518] *Id.* at 1377.
[519] *Id.*
[520] *Id.* at 1379.
[521] *Id.* at 1380–81.

corporation and who pays for those shares . . . can make a business judgment whether to buy into such a minority position, and if so on what terms."[522] Moreover, a stockholder intending to buy into a minority position in a Delaware corporation may enter into definitive stockholder agreements, and such agreements may provide for elaborate earnings tests, buyout provisions, voting trusts, or other voting agreements.[523] Consequently, the court believed that shareholders should protect themselves in this fashion rather than expecting courts to provide protection.[524]

b. Canada Southern Oils, Ltd. v. Manabi Exploration Co., 96 A.2d 810 (Del. Ch. 1953).

In this case, the Delaware Court of Chancery notably stated that "majority voting control is a right which a court of equity will protect under . . . [appropriate] circumstances."[525] Plaintiff, Canada Southern Oils, Ltd. ("Canada Southern"), controlled by the Buckleys, was the majority shareholder of Manabi Exploration Co. ("Manabi"), holding 50.4% of Manabi's outstanding stock.[526] The Buckleys and Cecil Hagan, the president of both Canada Southern and Manabi, had a mild disagreement about the management of Manabi.[527] Soon thereafter, a resolution authorizing Manabi's board to issue more shares at its sole discretion was adopted at a shareholder vote in which the plaintiff's shares were voted by a director and lawyer of Manabi by proxy.[528] The Buckley-Hagan rift grew deeper and Hagan resigned from his position at Canada Southern but not from Manabi.[529]

Hagan then engineered a board meeting of Manabi, and notified the company's directors by telegram of the board meeting to be held in Texas four days later.[530] The two directors representing the Buckleys, on receiving the notice in New York, objected to the meeting due to its short notice and suggested postponement, but the request was denied.[531] The other directors attended the meeting and authorized the sale of the unissued shares to a third company.[532] Thereafter, plaintiff filed an application for a preliminary injunction to prevent the issuance, transfer, or voting of those shares of Manabi's stock.[533] Plaintiff contended that Manabi sold the shares for an improper purpose, namely, to deprive plaintiff of clear voting control and to give it instead to the directors.[534]

The Court of Chancery dismissed Manabi's claim that the issuance was driven by a need for financing, and granted plaintiff's preliminary injunction blocking the issuance and transfer

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522 *Id.*
523 *Id.*
524 *Id.*
525 Canada S. Oils, Ltd. v. Manabi Exploration Co., 96 A.2d 810, 814 (Del. Ch. 1953).
526 *Id.* at 810–11.
527 *Id.* at 811–12.
528 *Id.* at 811.
529 *Id.* at 812.
530 *Id.*
531 *Id.*
532 *Id.*
533 *Id.*
534 *Id.*

of the new shares, stating:

> When the undisputed facts are viewed cumulatively I find it reasonable to infer that the primary purpose behind the sale of these shares was to deprive plaintiff of the majority voting control. Hagan and his associates did too much too soon with too little disclosure to justify a contrary conclusion.[535]

The court assumed and the defense conceded that, if the issuance was motivated by a desire to deprive plaintiff of control, it was an improper interference with shareholder voting.[536] The decision could be read to stand for the proposition that share issuances undertaken for the primary purpose of diluting the voting rights of majority stockholders were per se invalid.

V. ALTERNATIVE TO DELAWARE FOR INCORPORATION

Delaware has enjoyed the reputation of a management-friendly state, thus attracting companies to incorporate under its laws. Nevada provides a promising alternative for businesses to consider for incorporation.

A. Dearth of Case Law

Unfortunately, Nevada has only a limited amount of case law addressing shareholder oppression, so a complete assessment of how Nevada courts will treat various claims of oppression is not possible. While the majority of states allow dissolution as a remedy for oppression of minority shareholders by controlling shareholders, Nevada does not list oppression as a ground for dissolution.[537] However, "[t]he dissolution statutes do not provide the exclusive remedies for oppressed shareholders; courts have equitable powers to fashion appropriate remedies where the majority shareholders have breached their fiduciary duty to the minority by engaging in oppressive conduct."[538]

B. *Hollis v. Hill*, 232 F.3d 460 (5th Cir. 2000).

One significant Fifth Circuit case (applying Nevada law) suggests that Nevada courts may treat shareholder oppression claims as fiduciary duty claims, and hold the controlling shareholder liable.[539] In *Hollis*, the plaintiff and defendant jointly founded a Nevada corporation, and were each 50% shareholders, officers, and employees in the corporation.[540] The defendant took a more active role in the management of the corporation, and due to his vast control, he was treated by both the trial court and the Fifth Circuit as the "majority" shareholder.[541] Tension developed between the two shareholders, and the defendant implemented changes to the plaintiff's detriment, such as reducing and eventually terminating

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535 *Id.* at 813.

536 *Id.* at 812–13.

537 *See* NEV. REV. STAT. §78.650.

538 Hollis v. Hill, 232 F.3d 460, 468 (5th Cir. 2000) (applying Nevada law).

539 *Id.* at 470.

540 *Id.* at 463.

541 *Id.* at 466 n.16.

the plaintiff's salary, withholding financial information from the plaintiff, and closing one of the company's offices.[542] The plaintiff responded by filing suit, alleging shareholder oppression.[543]

Applying the internal affairs doctrine, the Texas courts determined that Nevada corporate law should determine the existence and scope of duties between the plaintiff and defendant.[544] Finding that dispositive decisions from the Nevada courts were "non-existent," the court was forced to consider analogous decisions, scholarly works, and other reliable data to determine what the highest court in Nevada would decide.[545] The court acknowledged that Nevada lacks a statute addressing shareholder oppression claims, but found that the defendant's actions constituted a breach of fiduciary duty, thus entitling the plaintiff to equitable relief.[546] Examining close corporation and partnership jurisprudence, the court concluded that the Nevada Supreme Court would likely "find fiduciary obligations between shareholders in a corporation such as . . . [the one at hand] operated by shareholder-directors."[547] The court determined that the absence of oppression as a ground for statutory dissolution in Nevada does not preclude the existence of a fiduciary duty.[548] Finding that a fiduciary duty was owed and breached by the defendant's oppressive conduct, the court ordered a buyout of the plaintiff's shares.[549]

The dissenting opinion disagrees with the majority's conclusion recognizing a cause of action for minority shareholder oppression under Nevada law.[550] Circuit Judge, E. Grady Jolly, states that "whether framed as a breach of fiduciary duty or statutory right," the majority had no basis under which to conclude that Nevada would accept such a claim.[551] Instead, Jolly states that "all indications are that Nevada attempts to pattern its corporate law after the management-friendly approach of Delaware, a state that clearly prohibits a cause of action for oppression of minority shareholders."[552]

Interestingly, the Respondent in *Rupe* cited Hollis v. Hill to argue that certain closely held companies approach a partnership situation, and urged that in those instances, fiduciary duties should be enforced.

VI. CONCLUSION

The assertion of a shareholder oppression claim is a relatively new concept in all U.S. jurisdictions. Some states, however, have developed a more cohesive body of law in this area

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542 *Id.* at 464.
543 *Id.*
544 *Id.* at 465.
545 *Id.*
546 *Id.* at 465–66.
547 *Id.* at 468.
548 *Id.*
549 *Id.* at 471–72.
550 *Id.* at 472 (Jolly, J., dissenting).
551 *Id.*
552 *Id.* at 473.

than others. Delaware in particular, though not flawless, provides standards that make the outcome of bringing and defending shareholder oppression claims more predictable. Without any decisions from the Texas Supreme Court, Texas is in the unenviable position of deciding cases without a controlling interpretation from its highest court. As such, it remains an amorphous, broadly defined, and inconsistently applied cause of action.

However, the Texas Supreme Court is now tackling this issue in *Rupe*.[553] Hopefully the court's ruling will provide much-needed guidance for Texas appellate courts to ensure predictability and uniformity in evaluating shareholder oppression claims. Texas would greatly benefit by modeling its development of this uncharted area of law after Delaware and implementing set standards by which to review alleged oppressive conduct. Established standards will prove advantageous to all parties by protecting minority shareholders from oppression, and advising controlling shareholders and directors of the paradigm by which their conduct will be measured. Until Texas outlines its position on oppression claims, businesses will likely continue to routinely select Delaware for incorporation, and perhaps Nevada, as well.

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[553] Ritchie v. Rupe, 339 S.W.3d 275 (Tex. App.—Dallas, *pet. granted*).

THE TEXAS UNIFORM TRADE SECRETS ACT

Joseph F. Cleveland, Jr. and J. Heath Coffman

In this past legislative session, the Texas Legislature enacted the Texas Uniform Trade Secrets Act ("TUTSA"). On September 1, 2013, Texas will join 46 other states that are currently governed by some form of the Uniform Trade Secrets Act.[1]

Before enactment of TUTSA, Texas had no central law governing trade secrets. Instead, Texas law on trade secrets was cobbled together from Texas common law, the Restatement of Torts, the Restatement (Third) of Unfair Competition, and the Texas Theft Liability Act. Much of this law was outdated (the Restatement of Torts was drafted in 1939) and was simply not designed for the technological developments of the modern era. As a result, Texas businesses and those businesses looking to expand to Texas were left to guess as to what proprietary information Texas law would and would not protect.

TUTSA codifies and modernizes Texas law on misappropriation of trade secrets by providing a simple legislative framework for litigating trade secret cases. Among other things, TUTSA provides an unambiguous and updated definition of trade secrets, a simplified means for obtaining injunctive relief and sealing court records, and an attorneys' fees provision for recovering fees from those parties who engage in willful and malicious activity.

What follows is a section by section analysis of TUTSA. Section 134A.002 of TUTSA contains a list of six new definitions, including definitions for "trade secret," "misappropriation," "improper means," "proper means," and "reverse engineering."

Definition of a Trade Secret. TUTSA provides an expansive definition of protectable trade secrets. Under section 134A.002(6) of TUTSA, "trade secret" means information, including a formula, pattern, compilation, program, device, method, technique, process, financial data, or list of actual or potential customers or suppliers that:

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

B. is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.[2]

This new statutory definition of a trade secret represents a significant change to Texas law.

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[1] Uniform Law Commission Enactment Status Map, http://www.uniformlaws.org/Act.aspx?title=Trade%20Secrets%20Act (last visited April 30, 2013).

[2] While the definition of "trade secret" includes lists of actual or potential customers or suppliers, in order to be protected, those lists must derive independent economic value from not being generally known or readily ascertainable by proper means and be the subject of efforts that are reasonable under the circumstances to maintain their secrecy. Thus, publicly available names of customers and suppliers would not meet the definition of a "trade secret" under TUTSA.

Before enactment of TUTSA, the definition of trade secrets was unchanged since it first appeared in the 1939 Restatement of Torts. Under Texas common law, a trade secret consisted of any formula, pattern, device, or compilation of information used in a business, which gives the owner an opportunity to obtain a competitive advantage over his competitors who do not know or use it.[3] To determine if a trade secret existed, courts applied Texas common law from an array of judicial opinions and weighed the six non-exclusive factors articulated in section 39 of the Restatement (Third) of Unfair Competition.[4]

Texas common law was unsettled as to whether there must be "continuous use" of a trade secret in order to afford that secret protection.[5] TUTSA, however, eliminates this "continuous use" requirement and extends protection to a plaintiff who has not yet had an opportunity or acquired the means to put a trade secret to use.[6] TUTSA thus results in a wider class of protected trade secrets, including trade secrets that have not yet been put to use or trade secrets that have been used but later abandoned.

Another change is the protection of "negative know-how." At least one federal court concluded that under Texas common law, a defendant does not misappropriate a trade secret by using negative "what not to do" information.[7] The new definition in TUTSA, however, "includes information that has commercial value from a negative viewpoint, for example the results of lengthy and expensive research which proves that a certain process will not work could be of great value to a competitor."[8]

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[3] *In re* Bass, 113 S.W.3d 735, 739 (Tex. 2003); Hyde Corp. v. Huffines, 314 S.W.2d 763, 776 (Tex. 1958) (quoting RESTATEMENT OF TORTS § 757 cmt. b (1939)).

[4] *In re* Bass, 113 S.W.3d at 739–40 (citing RESTATEMENT OF TORTS § 757 cmt. b (1939)); RESTATEMENT (THIRD) OF UNFAIR COMPETITION § 39 reporters n, cmt. d (1995). The six factors from section 39 of the Restatement (Third) of Unfair Competition are:

> 1) the extent to which the information is known outside of the business;
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> 2) the extent to which it is known by employees and others involved in the business;
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> 3) the extent of the measures taken to guard the secrecy of the information;
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> 4) the value of the information to the business and its competitors;
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> 5) the amount of effort or money expended in developing the information; and
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> 6) the ease or difficulty with which the information could be properly acquired or duplicated by others.

[5] *Compare Hyde Corp.*, 314 S.W.2d at 776 ("A trade secret is a process or device for continuous use in the operation of the business"), *with* Bertotti v. C.E. Shepherd Co., 752 S.W.2d 648, 653 (Tex. App.—Houston [14th Dist.] 1988, no writ) ("The mere fact that a company is not utilizing information at the present time does not prevent that information from being a trade secret subject to protection.").

[6] *See* UNIF. TRADE SECRETS ACT § 1 cmt. 5 (amended 1985) [hereinafter UTSA]. Under section 134A.008 of TUTSA, the Act is to be "applied and construed to effectuate its general purpose to make uniform the law with respect to the subject of this chapter among states enacting it." Tex. Unif. Trade Secrets Act, 83d Leg., R.S., S.B. 953, § 134A.008. Therefore, the comments to the UTSA and court decisions interpreting the Act constitute persuasive authority.

[7] Hurst v. Hughes Tool Co., 634 F.2d 895, 899 (5th Cir. 1981).

[8] UTSA § 1 cmt 5.

Finally, TUTSA provides a different formulation of the secrecy requirement for trade secret protection. Under Texas common law, "[b]efore information can be termed a trade secret, there must be a substantial element of secrecy."[9] A substantial element of secrecy exists when "except by use by improper means, there would be difficulty in acquiring the information."[10] Under TUTSA, a "trade secret" means information that "is the subject of efforts that are reasonable under the circumstances to maintain its secrecy."[11] This standard allows the fact finder to consider the nature of the trade secret and the facts and circumstances surrounding the efforts to maintain its secrecy in order to determine whether these efforts were reasonable under the circumstances.

Definition of Misappropriation. TUTSA specifically defines the conduct that constitutes misappropriation of a trade secret. Under TUTSA section 134A.002(3), "misappropriation" means:

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

This definition is a significant improvement over existing Texas law. First, it specifies that prohibited conduct includes: (1) acquiring a trade secret by improper means; or (2) disclosing a

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[9] Astoria Indus. of Iowa, Inc. v. SNF, Inc., 223 S.W.3d 616, 634 (Tex. App.—Fort Worth 2007, pet. denied).

[10] McClain v. State, 269 S.W.3d 191, 195 (Tex. App.—Texarkana 2008, no writ).

[11] Tex. Unif. Trade Secrets Act, 83d Leg., R.S., S.B. 953, § 134A.001(6).

trade secret without consent. Second, the definition makes clear that liability applies only to those *who know or have reason to know* a trade secret was acquired by improper means. Under Texas common law, this limitation was not explicit; in fact, only one federal court applying Texas law has indicated a willingness to apply it.[12] Thus, Texas common law imposed liability on defendants who obtained and used a trade secret by accident or mistake, such as a defendant who unknowingly acquires a competitor's trade secrets through a new employee, a customer, or the acquisition of an existing business.[13]

Under TUTSA, on the other hand, an employer is only liable for misappropriation if the employer knew or had reason to know that the trade secret was acquired by improper means. If, for example, an employee misappropriates a former employer's trade secrets and that employee uses those trade secrets in his new job, the new employer is not liable for misappropriation of trade secrets unless the employer had actual or constructive knowledge that the material was improperly obtained. Once the employer is put on notice (e.g., by a cease and desist letter or other means), the employer may be liable for continuing to use the misappropriated trade secret. Therefore, under TUTSA, the new employer is liable for damages for using the misappropriated trade secret only after acquiring knowledge of the employee's trade secret theft.

Definition of Improper Means. TUTSA's section 134A.002(2) provides a definition of improper means:

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

The definition of improper means clarifies that a license agreement may limit use of a trade secret by prohibiting reverse engineering. For example, many software license agreements specifically provide that a licensee may not reverse engineer, decompile, or disassemble software or attempt to obtain the source code. Under TUTSA, a breach of the duty to limit the use of trade secret information—a circumstance often imposed in license agreements dealing with computer software and other information—is included within the definition of "improper means." In contrast, the common law definition of "improper means" includes any instance where a person acts "below the generally accepted standards of commercial morality and reasonable conduct."[14]

Definition of Proper Means. Section 134A.002(4) provides a definition of proper means:

> "Proper means" means discovery by independent development, discovery by reverse engineering unless prohibited, or discovery or observation by any other means that is not improper.

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[12] *See* Metallurgical Industries, Inc. v. Fourtek, Inc., 790 F.2d 1195, 1204 (5th Cir. 1986) (applying a similar standard to the UTSA).

[13] *See, e.g.*, MGE UPS Sys. v. GE Consumer & Indus. Inc., 622 F.3d 361, 364 (5th Cir. 2010).

[14] Alcatel USA, Inc. v. DGI Techs., Inc., 166 F.3d 772, 785 (5th Cir. 1999).

The language "unless prohibited" clarifies that TUTSA does not affect license agreements prohibiting reverse engineering.

Definition of Reverse Engineering. Section 134.002(5) of TUTSA provides a definition for reverse engineering:

> "Reverse engineering" means the process of studying, analyzing, or disassembling a product or device to discover its design, structure, construction, or source code, provided that the product or device was acquired lawfully or from a person having the legal right to convey it.

Injunctive Relief. Section 134A.003 of TUTSA contains specific provisions for obtaining injunctive relief for actual or threatened misappropriation of trade secrets:

> a) Actual or threatened misappropriation may be enjoined. On application to the court, an injunction shall be terminated when the trade secret has ceased to exist, but the injunction may be continued for an additional reasonable period of time in order to eliminate commercial advantage that otherwise would be derived from the misappropriation.
>
> b) In exceptional circumstances, an injunction may condition future use upon payment of a reasonable royalty for no longer than the period of time for which use could have been prohibited. Exceptional circumstances include a material and prejudicial change of position prior to acquiring knowledge or reason to know of misappropriation that renders a prohibitive injunction inequitable.
>
> c) In appropriate circumstances, affirmative acts to protect a trade secret may be compelled by court order.

TUTSA eliminates the possibility of a perpetual injunction, particularly when the trade secret no longer exists because the information has become generally known.[15] Unlike Texas common law, TUTSA includes a specific provision permitting a court in exceptional circumstances to enter an injunction conditioning future use of the trade secret upon payment of a reasonable royalty.[16] Section 134A.003(c) also authorizes a court to order a party to return misappropriated trade secrets to the aggrieved party.

A handful of courts have interpreted the phrase "threatened misappropriation" found in this section to allow injunctive relief not only when a trade secret is disclosed but also when a trade secret will inevitably be disclosed.[17] Under the "inevitable disclosure" doctrine, a court

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[15] *See* Elcor Chemical Corp. v. Agri-Sul, Inc., 494 S.W.2d 204, 214 (Tex. Civ. App.—Dallas 1973, writ ref'd n.r.e.).

[16] Texas Uniform Trade Secrets Act, 83d Leg., R.S., S.B. 953, § 134A.003(b).

[17] *See, e.g.*, Bayer Corp. v. Roche Molecular Sys., 72 F. Supp. 2d 1111, 1117–20 (N.D. Cal. 1999) (collecting cases).

can enjoin a former employee from using or disclosing the former employer's trade secrets if the former employee performs duties in his new employment that would necessarily cause that employee to use or disclose the former employer's trade secrets.[18] TUTSA does not address the inevitable disclosure doctrine. Instead, TUTSA would allow the courts to develop this area of the law on a case-by-case basis.[19]

Damages. There are no differences between existing Texas common law and TUTSA regarding the economic damages available for trade secret misappropriation. Under Texas common law, the plaintiff was permitted to recover damages based on the value of what has been lost by the plaintiff (lost profits) or the value of what has been gained by the defendant (unjust enrichment).[20] The plaintiff also could recover a reasonable royalty for the defendant's use of the plaintiff's trade secret.[21] The same types of damages are available under section 134A.004(a) of TUTSA:

> In addition to or in lieu of injunctive relief, a claimant is entitled to recover damages for misappropriation. Damages can include both the actual loss caused by misappropriation and the unjust enrichment caused by misappropriation that is not taken into account in computing actual loss. In lieu of damages measured by any other methods, the damages caused by misappropriation may be measured by imposition of liability for a reasonable royalty for a misappropriator's unauthorized disclosure or use of a trade secret.

Under TUTSA, actual damages are "[i]n addition to or in lieu of injunctive relief." This language makes clear that an injunction does not foreclose the right to recover damages.

Exemplary Damages. Under section 134A.004(b) of TUTSA, if willful and malicious misappropriation is proven by clear and convincing evidence, the fact finder may award exemplary damages. TUTSA also includes a cap on the total amount of exemplary damages that can be recovered, limiting any exemplary damage award to an amount not exceeding twice the amount of actual damages. In contrast, Texas common law has no specific exemplary

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[18] Cardinal Health Staffing Network v. Bowen, 106 S.W.3d 230, 242 (Tex. App.—Houston [1st Dist.] 2003, no pet.).

[19] Based on existing precedent, it is unclear whether Texas courts would be inclined to adopt the "inevitable disclosure" doctrine. One Texas court of appeals, surveying Texas common law, has noted that "no Texas case [has] expressly adopt[ed] the inevitable disclosure doctrine, and it is unclear to what extent Texas courts might adopt it . . . ." *Bowen*, 106 S.W.3d at 242. However, other Texas courts of appeals have applied modified tests with similar attributes to the inevitable disclosure doctrine, holding that an employee could be enjoined from using a former employer's confidential information "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." *See, e.g.*, Conley v. DSC Commc'ns Corp., No. 05-98-01051, 1999 Tex. App. LEXIS 1321, at *8 (Tex. App.—Dallas Feb. 24, 1999, no pet.) (emphasis in original); *see also* T-N-T Motorsports v. Hennessey Motorsports, 965 S.W.2d 18, 21–23 (Tex. App.—Houston [1st Dist.] 1998, pet. dism'd); Rugen v. Interactive Bus. Sys., Inc., 864 S.W.2d 548, 552 (Tex. App.—Dallas 1993, no writ); Williams v. Compressor Eng'g Corp., 704 S.W.2d 469, 470–72 (Tex. App.—Houston [14th Dist.] 1986, writ ref'd n.r.e.).

[20] Carbo Ceramics, Inc. v. Keefe, 166 Fed. Appx. 714, 722 (5th Cir. 2006) (applying Texas law).

[21] Calce v. Dorado Exploration, Inc., 309 S.W.3d 719, 738 (Tex. App.—Dallas 2010, no pet.).

damages cap for misappropriation of trade secrets.[22]

Attorneys' Fees. Under Texas common law, there was no right to recover attorneys' fees for misappropriation of trade secrets. Parties, however, often sought their fees by filing a claim under the Texas Theft Liability Act, which provides for the recovery of attorneys' fees to the prevailing party.[23] Section 134A.005 of TUTSA requires a finding that a claim for misappropriation was made in bad faith or that the misappropriation was willful and malicious misappropriation before the court may exercise its discretion to award fees:

> The court may award reasonable attorneys' fees to the prevailing party if: (1) a claim of misappropriation is made in bad faith; (2) a motion to terminate an injunction is made or resisted in bad faith; or (3) willful and malicious misappropriation exists.

Preservation of Secrecy. Texas Rule of Evidence 507 provides that trade secret information is privileged and need not be disclosed absent protective measures imposed by the court. But prior to the enactment of TUTSA, there was no specific provision in Texas law for protecting the secrecy of a trade secret during court proceedings. Instead, parties ordinarily requested the court to enter a protective order under general discovery rules.[24] Parties would also seek to seal court records using the cumbersome procedures outlined in Texas Rule of Civil Procedure 76(a), which requires public notice and the public's opportunity to be heard.

Section 134A.006 of TUTSA provides a new rule governing the disclosure of trade secrets during a court proceeding:

> In an action under this chapter, a court shall preserve the secrecy of an alleged trade secret by reasonable means. There is a presumption in favor of granting protective orders to preserve the secrecy of trade secrets. Protective orders may include provisions limiting access to confidential information to only the attorneys and their experts, holding in-camera hearings, sealing the records of the action, and ordering any person involved in the litigation not to disclose an alleged trade secret without prior court approval.

TUTSA thus provides the ability for aggrieved parties to pursue their legal rights in court without fear of having to disclose the very information they are trying to keep secret.

Statute of Limitations. The three-year statute of limitations for misappropriation of trade secrets claims found in Texas Civil Practice and Remedies Code section 16.010 is retained.

Effect on Other Law. TUTSA section 134A.007 provides that the chapter displaces conflicting tort, restitutionary, and other laws of this state, but does not affect (1) contractual

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[22] Texas common law, however, does generally limit an award of exemplary damages to the greater of the following: (1) twice the amount of economic damages, plus any noneconomic damages (up to $750,000.00) found by the jury; or (2) $200,000.00. TEX. CIV. PRAC. & REM. CODE § 41.008(b).

[23] TEX. CIV. PRAC. & REM. CODE § 134.005(b).

[24] *See* TEX. R. CIV. P. 192.6(b).

remedies, whether or not based upon misappropriation of a trade secret; (2) other civil remedies not based on misappropriation of trade secrets; or (3) criminal remedies, whether or not based upon misappropriation of a trade secret.

Conclusion. TUTSA modernizes the law of misappropriation of trade secrets in Texas by providing a consistent and predictable statutory framework for the protection of trade secrets and litigating trade secret cases. TUTSA also marks a clear departure from a common law approach and adopts updated statutory standards for trade secret protection, which are now consistent with those laws governing the vast majority of jurisdictions in the United States.

ACCELERATION NOTICES—WHETHER HOLDER OF A NOTE GAVE PROPER NOTICE TO MAKER OF HOLDER'S INTENT TO ACCELERATE

By Brad Ratliff *

Mathis v. DCR Mortg. III Sub I, L.L.C., 389 S.W.3d 494 (Tex. App.—El Paso 2012, no pet. h.).

In the case of *Mathis v. DCR Mortg. III Sub I, L.L.C.*,[1] the El Paso Court of Appeals shed light on the particularities involved in creating a valid waiver of notice of the holder's intent to accelerate and notice of acceleration.[2] The language in the note was a clear and unequivocal waiver of both, but the deed of trust required notice of default and a cure period. The court held that the documents read together were ambiguous, so the waivers were ineffective and so was the acceleration. The El Paso Court of Appeals' opinion is significant because it addresses the issue concerning the risk of inconsistent document language on waivers of notice and intent to accelerate and of notice of acceleration.

In March of 2000, Lawrence Mathis signed a promissory note in connection with his purchase of a roughly 20,000 square foot building in Austin, Texas.[3] Mathis arranged for financing through Norwest Bank, N.A., an institutional lender (first lien holder), for approximately 50% of the purchase price.[4] Additionally, Mathis found second lien financing through CenTex Certified Development Corporation ("CDC") for approximately 40% of the purchase price.[5] Mathis provided the remaining 10% of the purchase price with a down payment.[6]

The note in question was made payable to first lien holder, Norwest Bank, N.A. and secured by a deed of trust.[7] The original principal sum of the note was $440,000.[8] DCR Mortgage III Sub I, L.L.C. ("DCR"), current owner and holder, acquired the note and deed in 2006.[9] Under the terms of the note, Mathis was to make payments of principal plus interest over a twenty year term.[10] The note had an acceleration provision that gave the holder a discretionary right to accelerate the maturity of all debt owed by Mathis.[11] Specifically, the acceleration provision gave the holder the right to accelerate in the event that "[Mathis/Makers] fail[s] to make timely any payment required by this Note or to perform

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1 389 S.W.3d 494 (Tex. App.—El Paso 2012, no pet. h.).

2 *Id.*

3 *Id.* at 497.

4 *Id.*

5 *Id.*

6 *Id.*

7 *Id.*

8 *Id.*

9 *Id.* at 498.

10 *Id.* at 497.

11 *Id.* at 498.

timely any other obligation owed to Holder . . . . . ."[12]

Furthermore, the note also contained a waiver of notice provision in connection with any potential acceleration:

> Each of Makers, each guarantor of any of the Indebtedness, and each person who grants any lien or security interest to secure payment of any of the Indebtedness, (i) except as expressly provided herein, waives all notices (including, without limitation, notice of intent to accelerate, notice of acceleration and notice of dishonor), demands for payment, presentment, protest and diligence in bringing suit and in the handling of any security;. . . .[13]

However, the deed of trust had the following language concerning potential default and acceleration:

> 5. If Grantor defaults on the note or fails to perform any of Grantor's obligations or if default occurs on a prior lien note or other instrument, and the default continues after Beneficiary gives Grantor notice of the default and the time within which it must be cured, as may be required by law or by written agreement, then Beneficiary may:
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> a) declare the unpaid principal balance and earned interest on the note immediately due.[14]

After DCR acquired the Mathis note around September 15, 2006, Mathis was still several months behind on payments.[15] Throughout 2007 and 2008 Mathis made several installment payments which were accepted by DCR.[16] In 2007, Mathis entered into a sales contract to sell the property secured under the note but the deal collapsed because Mathis was not pleased with negotiations.[17] However, in the third or fourth quarter of 2008, the partners of DCR decided that the company would no longer accept monthly payments from Mathis and that it would proceed with foreclosure.[18] A DCR representative acknowledged that he did not tell Mathis that DCR would no longer accept monthly payments.[19]

On February 25, 2009, Mathis attempted to bring the note current and mailed a check for three installment payments.[20] These payments were eventually rejected by DCR.[21] According

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[12] *Id.*
[13] *Id.*
[14] *Id.*
[15] *Id.*
[16] *Id.* at 499.
[17] *Id.*
[18] *Id.*
[19] *Id.*
[20] *Id.* at 500.
[21] *Id.* at 501.

to Mathis, he was completely unaware any acceleration on the note had occurred.[22] On April 10, 2009, an attorney appointed by DCR signed a foreclosure notice stating that a foreclosure sale was to take place on May 5, 2009.[23] A representative from DCR sent a letter to Mathis indicating that the note had been accelerated by an "Acceleration Notice" sent on February 19, 2007.[24] Mathis's attorney requested documentation evidencing an acceleration but neither the appointed attorney nor a representative from DCR responded to the request.[25]

On April 29, 2009 Mathis filed a declaratory judgment with regard to the parties' rights under the note and sought a temporary injunction to enjoin DCR from going forward with the foreclosure sale.[26] The trial court issued an order that conditionally granted Mathis's request.[27] On March 2, 2010, the trial court held a hearing on the matter and rendered judgment in favor of DCR.[28] The trial court found that the note had been accelerated and DCR was entitled to foreclose the deed of trust lien.[29] Upon request by Mathis, the trial court filed Findings of Fact and Conclusions of Law.[30] Mathis filed an appeal challenging the legal and factual sufficiency of the evidence to support the trial court's findings of fact and law.[31]

The court of appeals started its analysis by stating that "[i]t is clear that the holder of a note must ordinarily give notice to the maker of the holder's intent to accelerate the time for payment as well as notice of acceleration."[32] Next, the court outlined the principle that the maker may waive his right to notice of intent to accelerate and notice of acceleration.[33] Further, the court reiterated that the waivers are effective if they are contained in either a note or a deed of trust.[34] Most importantly, the court belabored the point that regardless of its location, the waiver of notice must be "clear and unequivocal." [35]

Mathis acknowledged that the waiver provision in the note was sufficient to show a clear and unequivocal intent to waive.[36] Nevertheless, Mathis's argument on appeal is that when the promissory note and deed of trust are read together as a single instrument, they do not indicate a "clear and unequivocal waiver of the maker's right to receive notice of the holder's intent to

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[22] *Id.*

[23] *Id.*

[24] *Id.*

[25] *Id.*

[26] *Id.*

[27] *Id.* The trial court's temporary injunction ordered that Mathis pay the tax loans. However, it did condition the continued effectiveness of the temporary injunction after August 3, 2009 upon the tax loans' being paid on or before that date. The tax loans were paid and the liens securing them released before August 3, 2009.

[28] *Id.*

[29] *Id.*

[30] *Id.* at 502.

[31] *Id.* at 504.

[32] *Id.* at 505 (citing Shumway v. Horizon Credit Corp., 801 S.W.2d 890 (Tex. 1991)).

[33] *Id.*

[34] *Id.*

[35] *Id.*

[36] *Id.*

accelerate maturity of the note."[37] Mathis relied on a provision in the deed of trust which required notice to be given prior to acceleration.[38]

Mathis, in support of his argument, depended heavily on the case of *Dolci v. Askew*,[39] where the San Antonio Court of Appeals' encountered a similar fact scenario: clear waiver language in the note coupled with inconsistent language elsewhere.[40] The San Antonio Court of Appeals' focused on reading the note as a whole in determining that the waiver was ineffective.[41] The court reasoned that the inconsistent language did not resolve all ambiguity regarding the waiver.[42]

The court found Mathis's argument consistent with prior case law and basic construction principles.[43] The court determined that the note and deed of trust must be read together "because they were executed by the same parties on the same day, they pertain to the same real property, each document references the other, and the deed of trust is identified as the security for the note."[44] Further, the court reiterated the principle that acceleration is not favored in the law and is considered as a harsh remedy.[45] Therefore, the court applied strict scrutiny to the acceleration provision and "if any reasonable doubt exists as to the parties' intent, we resolve such doubt against acceleration."[46] Also, the court propounded the idea that its primary duty in construing an instrument is to ascertain the parties' intent.[47] Applying these principles, the court held that the waiver was ineffective because the deed of trust casted doubt on whether the parties clearly and unequivocally intended to waive notice of default and time to cure.[48]

In conclusion, ambiguous language within a legal instrument or in different instruments within the same transaction may lead to litigation. Here, the El Paso Court of Appeals' decision is significant because it addresses this issue in relation to drafting an effective waiver of notice of intent to accelerate. *Mathis* serves as a reminder to carefully draft the waiver provisions in a consistent manner across all documents involved in the transaction.

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[37] *Id.*

[38] *Id.*

[39] No. 04-95-00867-CV, 1997 WL 428560, at *2 (Tex. App.—San Antonio July 30, 1997, no pet.) (mem. op., not designated for publication).

[40] *Mathis*, 389 S.W.3d at 506.

[41] *Id.*

[42] *Id.*

[43] *Id.* at 507.

[44] *Id.*

[45] *Id.*

[46] *Id.*

[47] *Id.*

[48] *Id.*

PURCHASING NOTES—WHETHER THE *PURCHASE* OF A PROMISSORY NOTE FROM THE NOTE HOLDER BY A THIRD-PARTY DISCHARGES THE NOTE

By Jessica Ebbs*

Anderton v. Cawley, 378 S.W.3d 38 (Tex. App.—Dallas 2012, no pet.).

In *Anderton v. Cawley*, the Dallas Court of Appeals addressed an infrequently applied rule of law concerning whether a third party's payment of a promissory note to the holder discharges the note obligation.[1] The court concluded this type of transaction is presumed to be a purchase rather than a payment and discharge of the note.[2] In stating the applicable rule, the court acknowledged recent authority is sparse but cited cases over 50 to 70 years old.[3] The decision is consistent with long-standing case law in Texas and other jurisdictions. In 2002, Lewie Anderton and William R. Cawley formed two partnerships—Cascade Properties, Ltd. and Bellwood Lake Partnership, Ltd.—to develop nearly 500 acres of land near Tyler, Texas.[4] Their aspirations included transforming the large parcel of land into a golf and residential community.[5] Each partnership was formed to serve a specific purpose.[6] The purpose for Cascades Properties, Ltd. ("Cascades Ltd.") was to develop the portion of the 500 acre land that was to be used for residential purposes, while the purpose for Bellwood Lake Partnership, Ltd. ("Bellwood Ltd.") was to acquire and improve an existing golf course that sat adjacent to the intended residential community.[7] Both partnerships were "headed by" Anderton under the entity Cascade Properties GP Corp., which served as the original managing general partner of the two partnerships.[8]

The development plan had three phases.[9] During phase one, Cawley informed Anderton that the costs for this part of the development exceeded his personal financial abilities and, accordingly, he recommended Cascades Ltd. borrow funds from Park Cities Bank (the "Bank") to cover this shortfall.[10] In fact, this proposed transaction would prove simple for Cawley, considering he was a 10% shareholder, director, and member of the loan committee for the Bank.[11] In 2003, Anderton agreed to Cascade Ltd.'s borrowing of $3 million from the Bank—an amount that, after being refinanced into a line of credit less than a year later, grew to $5.5 million.[12]

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1 378 S.W.3d 38 (Tex. App.—Dallas 2012, no pet.).

2 *Id.* at 49–50.

3 *Id.*

4 *Id.* at 42–43.

5 *Id.* at 43.

6 *Id.*

7 *Id.* at 42–43.

8 *Id.* at 43.

9 *Id.*

10 *Id.*

11 *Id.*

12 *Id.*

At the beginning of phases two and three, the relationship between Anderton and Cawley began to deteriorate.[13] Further, the intended development, yet again, lacked sufficient funding.[14] As a result and at different times in 2006, the Bank loaned $6.5 million to Cascades Ltd. and $13.325 million to Bellwood Ltd. Anderton signed and personally guaranteed the $13.325 million promissory note.[15]

In 2008, the tension between Anderton and Cawley continued to heighten and, as a result of many unsettled disputes, Anderton brought suit against Cawley in a Dallas County district court.[16] In February 2009, the Bank put Bellwood Ltd., including Anderton and Cawley, on notice that it was in default on the $13.325 million promissory note due to its failure to pay property taxes in 2008, plus the related interest amount, totaling $114,456.46.[17] On June 30, 2009, the Bank paid this amount of property taxes and interest on Bellwood Ltd.'s behalf as authorized by the executed loan documents.[18] On the same day, BOT Real Estate ("BOT"), a limited liability company formed by Cawley for the sole purpose of purchasing Bellwood Ltd.'s debt, wrote a check, signed by Cawley and payable to the Bank in the amount of $114,456.46.[19]

On the following day of July 1, 2009, the Bank demanded reimbursement of the property tax payment from Bellwood Ltd. and gave notice of its intent to accelerate the entire debt.[20] The notice was communicated by letter and explicitly stated that Bellwood Ltd. would be in default if the Bank was not reimbursed for the property tax payment by July 3, 2009 at 3:00 p.m.[21] Bellmont Ltd. did not make a reimbursement payment; consequently, the Bank assigned the Bellwood Ltd. $13.325 million promissory note and related liens and guaranties to BOT.[22] Soon after acquiring the note, BOT foreclosed on Bellwood Ltd.'s collateral.[23]

The lawsuit brought by Anderton in 2008 asserted numerous theories of liability against several parties, including Cawley and BOT.[24] After foreclosing on Bellwood Ltd.'s collateral, BOT asserted a counterclaim and later filed a traditional motion for partial summary judgment against Anderton on his guaranty of the promissory note seeking to recover the amount of the deficiency remaining after the foreclosure.[25] BOT asserted that its June 30 payment in the amount of the property taxes due served as partial purchase of the note, while Anderton countered by stating the June 30 payment cured Bellwood Ltd.'s default and thus, discharged

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13 *See id.* at 43.
14 *Id.* at 49–50.
15 *Id.*
16 *Id.* at 44.
17 *Id.*
18 *Id.*
19 *Id.* at 45, 48.
20 *Id.* at 44.
21 *Id.* at 47.
22 *Id.* at 44–45.
23 *Id.* at 45.
24 *Id.*
25 *Id.*

his obligations under the note.[26] The trial judge granted BOT's partial summary judgment motion and awarded BOT nearly $8.6 million in damages plus prejudgment interest against Anderton.[27] Further, the judge ordered Anderton take nothing on his previously asserted claims against BOT.[28]

On appeal, Anderton alleged that the evidence within the record raised a genuine issue of material fact as to whether Bellwood Ltd. was in default when BOT foreclosed on its property.[29] Anderton did not contest that Bellwood Ltd. was in default up to June 30, 2009 due to its failure to pay overdue property taxes.[30] The disputed issue, however, was whether the payment by BOT to the Bank of the exact amount of the deficient property taxes constituted a purchase or a payment and discharge of Anderton's obligation to BOT through his guarantee of the promissory note.[31] This was in doubt because the July 1, 2009 letter sent to Bellwood Ltd. indicated that default would result if reimbursement payment was not made.[32] Nonetheless, BOT wrote a check to the Bank on the following day for the exact amount of Bellwood Ltd.'s deficient property taxes.[33] Thus, for purposes of reviewing the summary judgment, the question was whether BOT's July 30 payment to the Bank was a purchase of the note or a payment and discharge of the obligation to Bellwood Ltd.[34]

In general, a party's obligation to pay an instrument is discharged if payment is made.[35] A payment is made under limited circumstances—"an instrument is paid to the extent payment is made by or on behalf of a party obliged to pay the instrument, and to a person entitled to enforce the instrument."[36] Contrary to the trial court's ruling, the Dallas Court of Appeals concluded the evidence presented was sufficient to survive the summary judgment stage of the proceeding.[37] The Court began its analysis by stating "the applicable rule of law is this: when a third party pays the holder of a note, the transaction is presumed to be a purchase and not a payment and discharge of the note unless evidence shows the parties to the payment intended otherwise."[38]

The Court cited a case decided in 1934, *Shanks v. First State Bank of Coahoma*,[39] involving a bank that purchased a note from the defendant and later brought suit to recover deficient funds, and quoted the relevant language from the court's analysis: "[T]he payment for and receipt of a note by a stranger to it, is presumptively a purchase and not a payment of the

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[26] *Id.* at 50.

[27] *Id.* at 45.

[28] *Id.*

[29] *Id.* at 47.

[30] *Id.*

[31] *Id.* at 49.

[32] *Id.*

[33] *Id.*

[34] *Id.*

[35] *See* TEX. BUS. & COM. CODE ANN. § 3.601 (West Supp. 2012).

[36] TEX. BUS. & COM. CODE ANN. § 3.602(a) (West Supp. 2012).

[37] *Anderton*, 378 S.W.3d at 51.

[38] *Id.* at 49–50 (citations omitted).

[39] 70 S.W.2d 444, 446 (Tex. Civ. App.—Eastland 1934, no writ).

note."[40] The Court also cited *Eberley v. First Nat'l Bank of Stanton*,[41] decided in 1954, as additional support.[42] The relevant language from the *Eberley* case stated that "[w]here a note is paid by a stranger thereto, it is generally held to be a purchase, not payment, of the note."[43] Furthermore, the Court cited several other cases with similar facts that laid out the applicable rule.[44]

After stating the applicable rule, the Court concluded that the evidence presented by Anderton raised a genuine issue of material fact of whether BOT's June 30, 2009 payment to the Bank in the exact amount of the deficient property taxes cured Bellwood Ltd.'s defaulting status.[45] Specifically, the Court stated:

> We conclude that the evidence raises a genuine issue of material fact on the question of whether BOT's June 30 payment cured Bellwood Ltd.'s default. Under the general rule, we presume that BOT's payment was intended as a purchase of the partnership's obligation unless there is evidence tending to show that BOT and the Bank intended for the payment to discharge the partnership's obligation instead.[46]

Moreover, the Court held that a material issue of fact existed in regards to BOT's and the Bank's intent.[47] In its reasoning, the Court explicitly referenced several key pieces of evidence.[48] Specifically, the Court examined BOT's check and check stub for the June 30, 2009 payment to the Bank in the amount of $114,456.46—the check stub reflected that the $114,456.46 figure was the sum of six different line items of different amounts, yet all six line items were labeled "08PropTaxBLP" in a separate column.[49] This was noteworthy because the six line items all referenced "08PropTaxBLP" and said nothing about a partial payment for acquisition of the Bellwood Ltd. note or any other distinction from simply "08PropTaxBLP."[50] Along with this finding, the Court also looked to other factors such as the check amount BOT

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[40] *Anderton*, 378 S.W.3d at 49 (citing *Shanks*, 70 S.W.2d at 446).

[41] 272 S.W.2d 532, 537 (Tex. Civ. App.—Austin 1933, writ ref'd).

[42] *Anderton*, 378 S.W.3d at 49.

[43] *Id.* (citing *Eberley*, 272 S.W.2d at 537).

[44] *Id.* at 49–50 (citing Vogel v. Cent. Tex. Sec. Corp., 62 S.W.2d 243, 245 (Tex. Civ. App.—Austin 1933, writ ref'd) ("The intention of the parties relative to the discharge of a debt when it is paid by a stranger to the holder either determines whether the debt is discharged or transferred . . .")). The Court also referenced other jurisdictions in the same time period which followed a similar rule. *Id.* at 50 (citing Bradley v. Lehigh Valley R. Co., 153 F. 350, 353 (2nd Cir. 1907) ("Payment of an obligation of another by a third party does not discharge it as between the original parties, unless the payment is made and received with the intention that it shall do so."); Proctor v. Pyle, 91 P.2d 187, 191 (Cal. Ct. App. 1939) ("When a note is paid after maturity by a stranger thereto, in the absence of evidence to the contrary, it is presumed the transaction constitutes a purchase of the instrument and not an extinguishment of the obligation."); Union Trust Corp. v. Fugate, 200 S.E. 624, 626 (Va. 1939) ("Ordinarily, [a payment by a stranger to a note] is to be considered as a purchase, in the absence of anything to show a contrary intention.")).

[45] *Anderton*, 378 S.W.3d at 51.

[46] *Id.* (citing *Shanks*, 70 S.W.2d at 446).

[47] *Id.*

[48] *Id.*

[49] *Id.* at 48, 51.

[50] *Id.* at 51.

wrote to the Bank matching the exact amount of the property taxes the Bank demanded from Bellwood Ltd.[51] Additionally, the Court examined the fact that the Bank paid the property taxes simultaneously with its receipt of BOT's funds.[52] Along with a few additional factors, the court reasoned that this evidence was sufficient to raise a reasonable inference that BOT and the Bank may have intended the June 30, 2009 payment to be on behalf of and for the benefit of Bellwood Ltd., thus curing Bellwood Ltd.'s default.[53]

After analyzing the evidence, the Court of Appeals found that the trial court erred in granting summary judgment in favor of BOT on its counterclaim.[54] Thus, the case was remanded back to the trial court for further consideration.[55]

The distinction to be recognized in *Anderton* is a third party paying the holder of a note, rather than a guarantor paying the debt. A third party is presumed to purchase the note, rather than to be making a payment on the note, and thus, acquires the lender's rights to any collateral, or other security, and the debt is not discharged.[56] But, if evidence demonstrates that parties intended a payment and resulting discharge to the obligor, it will so apply.[57] On the other hand, a guarantor of a note, or debt, who pays the debt of the principal is subrogated to all of the rights, remedies, equities, and security of the original creditor unless these rights have been waived.[58]

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[51] *Id.*

[52] *Id.*

[53] *Id.*; *see also supra* note 39.

[54] *Anderton*, 378 S.W.3d at 51.

[55] *Id.*

[56] *See id*. at 49–50.

[57] *Id.*

[58] *See* Bradford Partners II, L.P. v. Fahning, 231 S.W.3d 513, 517 (Tex. App.—Dallas 2007, no pet.) (citing Crimmins v. Lowry, 691 S.W.2d 582, 585 (Tex. 1985)).