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## CORPORATIONS

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**A**LTHOUGH the Texas Legislature was not in session during the Survey period<sup>1</sup> a few interesting corporation law cases were decided by Texas courts. The first, *Docudata Records Management Services, Inc. v. Wieser*,<sup>2</sup> deals with a strained interpretation of a corporate restructuring transaction. The remaining three cases all involve plaintiffs who were successful in piercing the corporate veil, at least at the trial court level.

It is often said that bad facts make bad law, but rarely has the truth of that adage been more evident than in *Docudata Records Management Services, Inc. v. Wieser*.<sup>3</sup> Keith Wieser was knowledgeable in the medical records retrieval business. He approached Moen and Hoff, the two shareholders of LRS Group, Inc. (LRS), about going into the business. Moen and Hoff agreed and caused LRS to create a new corporate subsidiary (Docudata) through which the business would be conducted. The parties agreed that the objective would be to develop Docudata's business to a point where it could be sold or taken public. Wieser was concerned that, eventually, he might not be rewarded for his contribution to the new business, so Moen and Hoff caused Docudata to enter into an agreement with Wieser whereby he would get a portion of the sale price "should [Docudata] be sold."<sup>4</sup> This contract was the basis for the case.

Over the next several years, the business flourished. Moen and Hoff continued to develop the holdings of LRS and entered into negotiations with a venture capital firm regarding additional capital. Through those negotiations, Moen and Hoff entered into a share exchange agreement with another company engaged in the records business. The agreement provided that Moen and Hoff would contribute their shares in LRS, the parent corporation of Docudata, to a newly-formed holding corporation (Comdoc) in exchange for fewer than twenty percent of the new corporation's shares. The other company would contribute the stock of one of its corporations in exchange for the remainder of the new corporation's

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1. October 1, 1997 through September 30, 1998.

2. 966 S.W.2d 192 (Tex. App.—Houston [1st Dist.] 1998, no pet. h.).

3. *See id.*

4. *Id.* at 194.

shares. The agreement also required that Docudata be merged into LRS within 90 days after the date of the agreement.<sup>5</sup> The transactions contemplated by the agreement were consummated as expected during the summer of 1993, and the companies began restructuring their operations to take advantage of the new situation.<sup>6</sup>

Wieser reasonably thought that the share exchange and merger transaction constituted a sale of Docudata that would entitle him to compensation, so he approached Moen and Hoff.<sup>7</sup> They denied that he was entitled to a bonus based on the transaction. Shortly thereafter, Wieser quit the company and went to work for a competitor. Within two weeks LRS and Docudata sued Wieser for breaching his non-competition agreement.<sup>8</sup> Wieser counterclaimed, alleging that LRS and Docudata had failed to pay the compensation due him upon the sale of the company.<sup>9</sup> The trial court found that Wieser had not breached his non-competition agreement but that LRS and Docudata had breached their obligation to pay his compensation when due. The court awarded Wieser just over \$135,000 in damages.<sup>10</sup>

Docudata appealed, and its first point of error was that the evidence was legally and factually insufficient to support the trial court's finding that Docudata was sold.<sup>11</sup> Wieser based his argument that Docudata had been sold on the fact that the ultimate control of the corporation had shifted from Moen and Hoff to a previously-affiliated corporation, and that Docudata's legal existence had terminated upon the merger with LRS.<sup>12</sup> He argued that any other interpretation would deny him the benefit of his bargain.<sup>13</sup>

The First Court of Appeals, however, took an extremely narrow view of the Docudata disposition. The court relied on the fact that immediately following the exchange transaction, the shares of Docudata were still owned by LRS—notwithstanding the obligation that the two corporations merge within 90 days.<sup>14</sup> The court somehow came to the conclusion that in order for Wieser's argument to succeed, the independent corporate existence of LRS and Docudata would have to be disregarded.<sup>15</sup> The court was not willing to take that step, and further believed that Wieser's rights were such as to "restrict the free transfer of stock" and should, therefore, be narrowly construed.<sup>16</sup> The court held that the share exchange and merger was "simply a restructuring in the

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5. See *id.* at 195.

6. See *id.*

7. See *Docudata*, 966 S.W.2d at 196.

8. See *id.*

9. See *id.*

10. See *id.*

11. See *id.*

12. See *Docudata*, 966 S.W.2d at 196-97.

13. See *id.* at 197.

14. See *id.* at 198.

15. See *id.*

16. *Id.*

corporate form of the subsidiary's business" that did not rise to the level of a sale.<sup>17</sup> The court reversed and rendered judgment that Wieser take nothing,<sup>18</sup> proving once again that no good deed goes unpunished.

*Menetti v. Chavers*<sup>19</sup> presented the San Antonio Court of Appeals with an opportunity to apply the recently-amended language of TBCA article 2.21(A)(2), which protects a corporate shareholder from personal liability for a corporate contractual obligation (or other matter arising from or relating to that obligation) under the alter ego or similar theory unless an actual fraud directly benefitting the shareholder is proven.<sup>20</sup> The facts indicate that the Chavers signed a contract with Menetti & Co., Inc. for the construction of an addition to their home. The construction work was faulty, so the Chavers sued Menetti & Co., Inc. for breach of contract, fraud, deceptive trade practices, and negligence, and also named shareholders Vincent and Felecia Menetti as individual defendants under the alter ego theory.

The pretrial and trial proceedings in this case were quite poorly handled by the trial court, as evidenced by one error rising to the level of abuse of discretion,<sup>21</sup> and resulted in a generally confusing situation.<sup>22</sup> The corporation's pleadings were stricken and a default judgment was entered against the corporation because the entity had failed to obtain legal counsel within a three-day period previously ordered by the court (even though the entity had retained counsel several months before trial) and because the corporation was not current on its franchise taxes on the day of trial.<sup>23</sup> The corporation's counsel requested that the entity be permitted to defend itself if the taxes were paid by the next day, but the request was denied. Therefore, the corporation was not allowed to present a defense at trial. The apparent confusion in the proceedings resulted in the Menettis presenting a defense only as to damages.<sup>24</sup> The jury found in favor of the Chavers and awarded them \$137,000 (which the judge later reduced to \$97,000).<sup>25</sup> Judgment was entered against the Menettis individually, based on the Chavers' alter ego assertions. The Menettis' motion for new trial was refused.<sup>26</sup>

The Menettis filed an appeal on behalf of the corporation, but later dismissed that appeal. Next, they appealed the judgment against themselves claiming, among other things, that the trial court erred in not allowing them to individually assert defenses to the plaintiff's causes of action.<sup>27</sup> The Chavers responded that the Menettis had no standing to

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17. *Docudata*, 966 S.W.2d at 198.

18. *See id.* at 199.

19. 974 S.W.2d 168 (Tex. App.—San Antonio 1998, no pet. h.).

20. See TEX. BUS. CORP. ACT ANN. art. 2.21(A)(2) (Vernon Supp. 1998).

21. *See Menetti*, 974 S.W.2d at 172 n.6.

22. *See id.* at 173, n.7.

23. *See id.* at 170.

24. *See id.*

25. *See id.*

26. *See Menetti*, 974 S.W.2d at 170.

27. *See id.*

bring claims as to the merits of the judgment against the corporation because they had filed their appeal as individuals. The court of appeals properly reasoned that because there was no individual harm to the Menettis without a piercing of the corporate veil of some sort, they were not directly injured as a result of the default judgment against the corporation.<sup>28</sup> That reasoning disposed of all claims that the trial court erred in finding liability by the corporation.<sup>29</sup>

The Menettis next claimed that they were not given an opportunity to defend the alter ego allegations made by the Chavers, which was the only basis for holding the Menettis personally liable for the corporation's obligations.<sup>30</sup> The court of appeals found that whether the Menettis were allowed to defend was "unclear from the record,"<sup>31</sup> but also concluded that the Chavers had failed to introduce legally sufficient evidence to pierce the Menetti & Co., Inc. corporate veil under the standard of newly-amended TBCA article 2.21(A)(2).<sup>32</sup> As amended, that section provides that no shareholder can be held personally liable for any contractual obligation of the corporation, or any matter relating to or arising from the obligation, without a showing that the shareholder worked an actual fraud on the obligee of the contract which accrued primarily to the personal benefit of the shareholder.<sup>33</sup> The court of appeals recognized that the claims made in this case related to or arose from a contractual obligation of the corporation, were properly within the scope of TBCA article 2.21(A)(2), and required a demonstration of actual fraud to pierce the corporate veil.<sup>34</sup> The court also noted that a "finding that no actual fraud was committed destroys not only the attempt to pierce the corporate veil by a showing of an alter ego, but by 'other similar theor[ies]'."<sup>35</sup>

After a detailed review of the record, the court of appeals found that the Chavers had not presented sufficient evidence of actual fraud by the Menettis.<sup>36</sup> This finding precluded holding the Menettis personally liable for the obligations of their corporation, so the judgment against the Menettis was reversed.<sup>37</sup> The default judgment against the corporation, Menetti & Co., Inc., was unaffected.

Another alter ego case, *Harwood Tire v. Young*<sup>38</sup>, arose from an on-the-job injury. Faron Young sued his employer, Harwood Arlington, Inc. (HAI), along with its parent corporation, Harwood Tire, Inc. (HTI), alleging that HAI was HTI's alter ego.<sup>39</sup> About 30 days before the injury,

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28. *See id.* at 171.

29. *See id.* at 172.

30. *See id.* at 173.

31. *Id.*

32. *See id.*

33. *See Tex. Bus. Corp. Act Ann.* art. 2.21(A)(2) (Vernon Supp. 1998).

34. *See Menetti*, 974 S.W.2d at 174.

35. *Id.* (quoting *Tex. Bus. Corp. Act Ann.* art. 2.21(A)(2) (Vernon Supp. 1998)).

36. *See id.* at 176.

37. *See id.*

38. 963 S.W.2d 881 (Tex. App.—Ft. Worth 1998, no pet.).

39. *See id.* at 884.

HTI, which had been Young's employer, was reorganized such that it became a holding company for four subsidiary corporations. One of those corporations, HAI, employed Young. A jury found that HAI was the alter ego of HTI, and HTI and HAI appealed.<sup>40</sup>

When Young began working for HTI, it owned three tire stores, one each in Arlington, Bedford, and Irving. Young was the service manager at the Arlington store. In June 1992, Frank Roszell, who owned all the stock of HTI and was the sole director, created four subsidiary corporations—one to hold the assets of each store (including HAI) and one, Harwood CSF, Inc. (HCSF), which owned all real estate formerly held by HTI. Roszell was the sole director of all the subsidiaries, which were all wholly-owned by HTI, but his wife and others were officers of the subsidiaries. The rationale for this reorganization was that Roszell believed HTI would grow and prosper under this format. Testimony indicated that limiting liability was a minor factor in this decision to reorganize.<sup>41</sup>

In reviewing the evidence presented at trial, the court noted that each subsidiary had its own bylaws, articles of incorporation, and federal tax identification number. "Corporate formalities were observed, and intercompany transfers were documented."<sup>42</sup> The court then looked at the facts surrounding the inadequate capitalization theory, as well as the alter ego theory, effectively intermingling the analysis. The court noted that as part of the reorganization, HAI was allocated \$154,000 in assets, along with \$98,000 in retained earnings. Roszell testified that HTI was more capable of paying a judgment before the reorganization than after.<sup>43</sup> The court also noted that Roszell had blanket authority to manage the subsidiaries after the reorganization, even though he was not an officer of the subsidiaries. Nothing changed from a marketing perspective at the tire stores, and Roszell's CPA continued to do work for HAI after the reorganization, which was paid for by HTI.<sup>44</sup>

What the court focused on, however, was the fact that Roszell essentially bankrupted HAI through intercompany payments. In 1992, HAI paid \$50,000 of Roszell's \$102,000 salary. Additionally, even though HAI was characterized as barely breaking even at the end of 1993, it paid Roszell a \$47,000 management fee shortly before it was closed in December of 1993.<sup>45</sup> While the court noted that HAI owed no debts and closed with \$36,000 in assets, the court concluded that Roszell was using HAI as a business conduit of HTI. For example, the HTI name was used synonymously throughout all the stores. HAI never signed a separate lease for its store, nor did any assignment occur after the reorganization. Additionally, after HTI transferred all its real estate to HCSF, which consisted of the Irving store location, HAI paid rent to HCSF even though it had

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40. See *id.*

41. See *id.* at 885.

42. *Id.*

43. See *Harwood Tire*, 963 S.W.2d at 885-86.

44. See *id.* at 886.

45. See *id.*

no real presence in that office. The payments were used to pay down the Irving real estate but HAI got no ownership interest in the property.<sup>46</sup> Roszell could not explain why HAI would make payments for which it received no benefit.

The court found there was sufficient evidence to support the jury's findings disregarding the corporate fiction and finding HTI liable for the injury to HAI's employee, Young.<sup>47</sup> The moral of the story is that while the general corporate formalities were followed, the evidence certainly suggested that Roszell treated the various companies as his personal bank accounts, allowing the court to uphold the jury's determination.

*Love v. State of Texas*<sup>48</sup> arose from an action by the State of Texas to enforce a final order issued by the Railroad Commission assessing administrative penalties against Sopresa Petroleum, Inc. (Sopresa) for failure to plug inactive wells. The State sought to show, and the jury found that, Jeff Love (Love) and Daniel Welch (Welch) were individually liable for Sopresa's debts as a result of piercing Sopresa's corporate veil.<sup>49</sup> In affirming the trial court's findings, the Austin Court of Appeals reviewed the undisputed facts and applicable law.

Sopresa was the registered operator of two Texas oil and gas leases, the "Klein" and the "VIM." Until Sopresa was allegedly sold in 1986, Welch and Love were the sole shareholders and directors. Welch's father acted as a vice president of the company. Sopresa, as the operator of the Klein and VIM, was statutorily liable for failing to properly plug the wells.<sup>50</sup> From 1984 to 1986, several notifications were sent to, and received by, Sopresa advising it of the violations. In late 1986, Welch and Love transferred another lease (the Ogden lease) from Sopresa to another company they controlled, Calidad Petroleum (Calidad). That well was producing oil and gas in marketable quantities, unlike the Klein and VIM. Just three days after transferring the Ogden lease to Calidad, Love and Welch allegedly sold Sopresa to Luis Ybarra, a Mexican citizen.<sup>51</sup> Ybarra supposedly paid \$1,000 for Sopresa, which included the two leases and some equipment allegedly left at the sites to cover the cost of plugging the wells. The Railroad Commission implied that Ybarra never existed, and photos revealed that there was no equipment at the sites.<sup>52</sup>

A few months after the alleged sale to Ybarra, the Railroad Commission received a letter from Love indicating that he and Welch no longer controlled Sopresa, that Welch's father had resigned, and that Love was no longer the registered agent. No one was able to locate Ybarra at the Arizona address supplied by Love. The Railroad Commission issued final orders assessing administrative penalties against Sopresa in 1988 and

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46. See *id.*

47. See *id.*

48. 972 S.W.2d 114 (Tex. App.—Austin 1998, pet. denied).

49. See *id.* at 115.

50. See *id.* at 116-117.

51. See *id.* at 116.

52. See *id.*

1993, and the wells were plugged by the State. The State then sued Sopresa, Love, and Welch, and won.<sup>53</sup>

The State had successfully alleged that Sopresa was the alter ego of Love and Welch, and that Sopresa had been used by them as a sham. The court of appeals held that the jury's finding that Welch and Love used Sopresa as a sham did not conflict with a finding that Welch and Love were not shareholders, directors, or officers.<sup>54</sup> The court noted that Texas law does not require an individual to be a shareholder at the time liability is assessed if the corporation is a sham used to perpetrate a fraud.<sup>55</sup> The corporation will often have been dissolved, declared bankrupt, or sold by the time the case is tried and liability assessed. Love and Welch could not escape liability because they were no longer in their positions when the wells were plugged or the final orders entered.<sup>56</sup>

Love and Welch also argued that a finding of actual fraud was required to support the sham theory under TBCA article 2.21. The court stated, however, that the standard of actual fraud only applies to contractual obligations.<sup>57</sup> In this case, the State sought to recover for violations of rules relating to pollution and plugging expenses. Texas courts have recognized that such debts are fundamentally different from contractual obligations.<sup>58</sup> Therefore, the court held that the penalties, costs, and fees levied against Welch and Love were not contractual and that no showing of actual fraud was required to uphold the finding that they used Sopresa as a sham.

Finally, the court turned to the issue of whether there was sufficient evidence to support the "sham" finding. Reciting the long-standing rule, the court stated that the corporate fiction will be disregarded to prevent the use of the corporate entity as a cloak for fraud, illegality, or to work injustice.<sup>59</sup> The court noted that the transfer of the Ogden lease shortly after the notices of violations (and just days before the allegedly fraudulent sale) clearly supported the sham theory, and the fact that no one was able to locate Ybarra added further support. Hence, the court found sufficient evidence for the jury to have concluded that Love and Welch manipulated Sopresa's corporate form to escape their statutory obliga-

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53. See *Love*, 972 S.W.2d at 116.

54. See *id.* at 117. The court further stated that it need not reach the question of whether the alter ego theory conflicted with the jury's other findings because it upheld the jury's findings on the distinct "sham" theory. See *id.* at 117 n.2. While the court did not directly address the issue, a question may be raised as to whether one must be a shareholder, director, or officer to be found to be the alter ego of a corporation. This should serve as a wake-up call to lawyers seeking to pierce the corporate veil—if the facts support and require it, alternative pleading of alter ego and "sham" theories may keep their client in court and avoid this question.

55. See *id.* at 117 (citing *Huff v. Harrell*, 941 S.W.2d 230, 234 (Tex. App.—Corpus Christi 1996, writ denied)).

56. See *Love*, 972 S.W.2d at 117.

57. See *id.* at 118.

58. See *Serna v. State*, 877 S.W.2d 516, 519 (Tex. App.—Austin 1994, writ denied).

59. See *Love*, 972 S.W.2d at 119 (citing *Castleberry v. Branscum*, 721 S.W.2d 270, 273 (Tex. 1986)).

tions and acted against public policy, making it necessary to pierce the corporate veil to prevent injustice.<sup>60</sup>

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60. See *Love*, 972 S.W.2d at 120. The court also cited numerous cases with similar facts; *Klein v. Sporting Goods, Inc.*, 772 S.W.2d 173, 176-77 (Tex. App.—Houston [14th Dist] 1989, writ denied)(sole shareholder liable for company debts when he incorporated new business to continue business of foreclosed company); *Speed v. Eluma Int'l, Inc.* 757 S.W.2d 794, 797-98 (Tex. App.—Dallas 1988, writ denied) (individuals liable when shareholder set up scam involving a foreclosure-sale transaction in which the shareholder sold the bankrupt company's assets to a viable company).